December 1958

THE CANADIAN CHARTERED ACCOUNTANT

THE CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS

MANAGEMENT PLANNING & CONTROL

Four 1958 Annual Conference Papers

Partnership Buy-and-Sell Agreements

The Small Store: Sales and Credit Problems

Chartered Accountancy as a Profession

Internal Control in a Small Company

Break-Even Analyses in Management

ACCOUNTING RESEARCH: Long-Term Debt Expenses
TAX REVIEW: Taxation of Foreign Companies in Canada
ADMINISTRATIVE ACCOUNTING: Inventory Management

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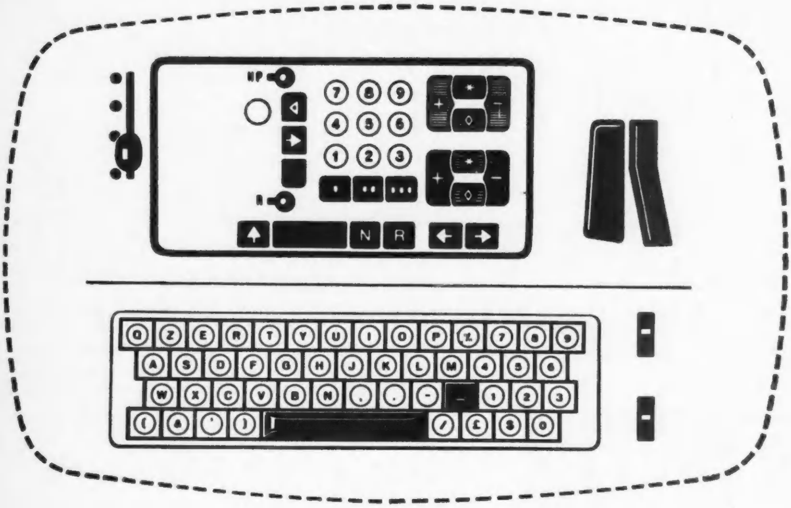

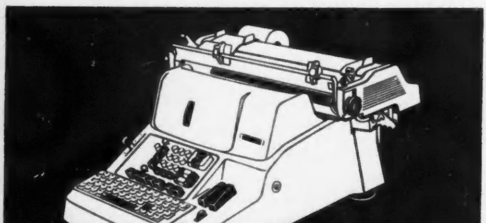

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IN THIS ISSUE

J. L. CARPENTER, LL.B. (page 517)

The buying of partnership interests through the use of life insurance is likely to increase, writes John L. Carpenter in "Partnership Buy-and-Sell Agreements". In setting forth this theory, the author offers some valuable suggestions to those not too familiar with the workings of buy-and-sell agreements and shows how the partners concerned can derive a financial cushion which may be needed to give stability to the business operations of the firm.

Mr. Carpenter is assistant legal officer with the Great West Life Assurance Company in Winnipeg and is currently in charge of the advanced training department of the firm's agency division. He is a member of the Canadian and Manitoba Bar Associations and the Life Underwriters Association of Canada.

W. A. BRADSHAW, C.A. (page 511)

Most small companies want to see their businesses run efficiently but, writes William A. Bradshaw in his article "Internal Control in a Small Company", when it comes to setting up some kind of internal control, the owners "look upon it with suspicion, especially if it involves more work and increased costs". The author proposes a plan whereby a satisfactory system of internal control in its broadest sense will result in sound accounting and, at the same time, give management a variety of useful statistics and estimates which may be required by the various executives.

Mr. Bradshaw is a partner in the Toronto office of Thorne, Mulholland, Howson & McPherson and a member of the Institute of Chartered Accountants of Ontario.

BRUCE C. WILLIS, C.A. (page 524)

The purpose of break-even analysis is to discover the area where revenue from sales is sufficient to offset all the costs and to focus the attention of management on the burden of fixed costs which have to be borne regardless of variations in the volume of production. While it is recognized as a tool of management control which could be applied to any company, it is of more general interest to manufacturing enterprises. In "The Use of Break-even Analyses in Management", Bruce C. Willis goes into the many issues involved and suggests some of the advantages to be gained by management from the interplay of such factors as prices, costs, volume and inventory levels. His article points out that break-even analyses are a by-product of the initial spadework required in developing fixed and variable cost segregations for a system of budgetary control.

Mr. Willis is a vice-president of Payne-Ross Limited, Montreal. His career started with Clarkson, Gordon & Co. Ltd. before going to Shell Oil of Canada as chief auditor and manager of the systems department. After holding several senior financial positions in industry, he returned to public practice and, in 1957, was appointed director of management services for George A. Touche & Co. On amalgamation with P. S. Ross & Sons early in 1958, he joined his present company. He is a member of the Institute of Chartered Accountants of Ontario, the American Management Association and the National Association of Accountants.

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PETER WRIGHT, Q.C. (page 529)

Professional men are probably as sensitive as any regarding the effort of other vocational groups to acquire the status of a profession without taking on those qualities of leadership and responsibility which are traditionally associated with professional standing. In examining the criteria of true professional status, Peter Wright, in his article "Chartered Accountancy as a Profession", lays emphasis on the chartered accountant's high standard of independence, "to keep it pure and absolute". On most counts, the accounting profession qualifies, claims the author, but there are some features where he suggests limitations and these will be of special interest to our readers.

Mr. Wright is a partner in the legal firm of Wright & McTaggart, Toronto, and, in the course of his work, has had much to do with chartered accountants. He is well qualified to write on this subject and has made a study of professional people ("What is a Profession?" — *The Canadian Bar Review,* Aug.-Sept., 1951). He was called to the Bar in 1934 and is presently chairman of the Canadian Board, Scottish Union and National Insurance Company and a director of several manufacturing companies. This article is a summary of an address on "Professional Life and Status" which he gave to The Canadian Institute of Chartered Accountants' Annual Conference in Montreal last September.

T. H. SHEPHERD, C.A. (page 533)

To strengthen his chances of survival in the present era of stiff competition, the small retailer needs to be more widely aware of some of the more important aids to successful management. In "The Small Store:

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Sales and Credit Problems", Thomas H. Shepherd gathers up all the procedures necessary in preparing sales records which form such a vital part in the making of decisions on financial policy. In addition, he has some sound advice to offer on controlling credit and collection procedures.

Mr. Shepherd is a partner in Harris, Fingarson & Co., Regina, and obtained his certificate in chartered accountancy in 1948. Prior to joining his present firm in 1952, he served for four years as corporation assessor with the Federal Income Tax Department. He is a member of the Institute of Chartered Accountants of Saskatchewan.

EDITORIAL (page 507)

This month's editorial "Must We Follow C.I.C.A. Research Bulletins?" by T. A. M. Hutchison is extremely timely. Some of the more recent bulletins are beginning to impinge on the work of the smaller practitioner and bring his problems closer to home. Preparing bulletins is a painstaking, detailed process and is the result of the experience and judgment of many practising accountants. The bulletins represent order amid the conflicting principles of accounting practice and, as the author puts it – "to ignore them may subject the practitioner to considerable peril".

Mr. Hutchison is senior partner of Peat, Marwick, Mitchell & Co., Toronto, a former chairman of the Board of Governors of the Canadian Tax Foundation and, from 1952 to 1957, served as treasurer of the Canadian Institute of Chartered Accountants. For the past two years, he has been a member of the Institute's Committee on Accounting and Auditing Research and a year and a half ago was appointed its chairman.

C. A. Pollock, President, Dominion Electrohome Industries Limited

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NOTES AND COMMENTS

Tax Foundation Conference

An estimated 500 chartered accountants and lawyers attended the annual conference of the Canadian Tax Foundation in Winnipeg from November 13 to 15.

Speakers at the conference included Dean M. E. LaZerte of the University of Manitoba and C. W. Gilchrist, managing director of the Canadian Good Roads Association, who presented papers on "The Next 10 Years in Education Finance" and "The Next 10 Years in Highway Finance", respectively. A. K. Eaton, fiscal consultant and former Assistant Deputy Minister of Finance, Hon. James Sinclair, president of the B.C. Fisheries Association, and Blair Fraser, Ottawa editor of *MacLean's Magazine*, spoke on "The Annual Process of Tax Changes". Hon. Duff Roblin, Premier and Provincial Treasurer of Manitoba, addressed the annual banquet.

The conference also featured panel discussions on sales tax, company amalgamations, legal and accounting principles governing deductible expenses, estate tax, uniform assessment of real property, Commonwealth economic affairs, taxation in the petroleum industry and methods of enforcement of the personal income tax.

New Tax Publication

The question of the true nature of an expense or outlay that may properly be chargeable in the determination of net income or profit is the subject of a new study entitled "Business Deductions under the Income Tax" by Gwyneth McGregor, Editor of *The Canadian Tax Journal*, published in October by the Canadian Tax Foundation. Mrs. McGregor describes briefly the principles on which the Canadian system of deductions is based, then considers the jurisprudence involved, and lastly attempts to assess the present position. Copies of this worthwhile brochure may be obtained from the Canadian Tax Foundation, 154 University Avenue, Toronto for $1.00 each.

The fourth analysis of the program of revenues and expenditures of the Government of Canada has also been released recently by the Canadian Tax Foundation. Under the title "The National Finances", this brochure has been enthusiastically received by members of Parliament, teachers, students, professional and business men as a source of unbiased information on the operations of the national government. Copies of it also are available from the Foundation at the above address.

Internal Auditors' Conference

Approximately 200 attended the one-day North-East Regional Conference of the Institute of Internal Auditors on October 31 at the Royal York Hotel in Toronto. The theme of the conference was "A Day in the Life of an Internal Auditor" and several chartered accountants took a prominent part in the program. Speakers at the sessions included J. F. Kid-

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ner, treasurer, Canadian Oil Companies Limited, Toronto; C. L. King, senior partner, Deloitte, Plender, Haskins & Sells, Toronto; and J. A. Edds, manager, internal audit and accounting methods, The Ontario Paper Company Limited, Thorold, Ont. A. E. Stead, G. H. Ward and B. G. Childs, were members of the Conference Committee.

Accountants over the Top

The accountants' section of the individual and professional division of the United Appeal of Metropolitan Toronto was the first section to go over the top, reaching 100.2% of its objective. L. J. Smith was chairman and C. L. King, vice-chairman of the section which had as its objective a total of $71,000.

Quebec Institute Submission

Full and fair disclosure in financial statements is called for by a submission in "Minimum Requirements Governing Financial Statements" made by the Institute of Chartered Accountants of Quebec to the Quebec Securities Commission. The Quebec Securities Act provides that prospectuses shall give a full disclosure of relevant facts as prescribed by the regulations but so far the regulations have not been issued. The Quebec Institute submission recommends the requirements it thinks the regulations should contain.

There is a recommendation for making reference to events occurring between the date of the balance sheet and the date of the prospectus that materially affect the assets or liabilities. The submission also calls for stating any change in accounting principle or practice that affects comparability of results shown in the earnings statement and for disclosing commitments under long-term leases.

Attention is given to consolidations, the circumstances in which the Commission may permit the exclusion of one or more subsidiaries from consolidations, and, where permission is so granted, the disclosure required as to the operations of those subsidiaries.

Another feature of the submission is the recommendation that the auditor shall have no material interest in the company and that, for the purpose of establishing his independence, he shall disclose to the Commission details of any financial interest he may have in the company and any relationship he may have had with the company as a promoter, underwriter, director or officer.

The committee which prepared the submission was made up of William S. Munro, chairman, George P. Keeping, Campbell W. Leach, J. E. Seybold, Jean Valiquette and M. Laird Watt.

Annual Report Awards

Among Canadian winners in the 14th annual reports contest sponsored by *The Financial World*, New York were Imperial Oil Limited, St. Lawrence Corporation and Southam Company Limited.

Additional Service to Readers

At the back of this issue of *The Canadian Chartered Accountant* readers will notice an index to volume 72 (January to June 1958) and to volume 73 (July to December 1958). For the first time a topical index has been included, as well as the regular alphabetical index by title and by contributor. The alphabetical index itself has been expanded to include Notes and Comments, book reviews and tax cases. In the future the index will be published at the end of each volume. It is hoped that this additional feature will prove valuable to the many readers who wish to refer to past issues of the magazine.

Editorial

MUST WE FOLLOW C.I.C.A. RESEARCH BULLETINS?

RESEARCH WAS being carried out within the accounting profession long before it was expressed in the form of research bulletins. Much work in the area of research was performed by individuals and found its way into the text books on accounting which have been the foundation for the accounting training of members of our profession.

Views on accounting research were first issued in the form of bulletins by the American Institute of Certified Public Accountants in 1938, and in the years since, numerous bulletins have been issued by that Institute. A similar development took place in the United Kingdom commencing in 1942 when the Institute of Chartered Accountants in England and Wales issued its "Recommendations on Accounting Principles". In Canada, a Committee on Accounting and Auditing Research was formed by the Canadian Institute of Chartered Accountants immediately after the end of the war, and its first bulletin was issued in October 1946.

Research bulletins to a substantial extent represent formal statements of the views of the profession as to accounting principles. The form of accountants' report on financial statements of United States business enterprises normally includes at the end of the opinion paragraph a statement to the effect that the balance sheet and statement of income present fairly the financial position and the results of operations for the year in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. The standard form of audit report recommended in C.I.C.A. Research Bulletin No. 6 and its supplement does not call for the inclusion of a similar statement as to being in conformity

with generally accepted accounting principles applied on a consistent basis. But the last paragraph of the supplement to bulletin No. 6 makes it clear that the Committee on Accounting and Auditing Research considered that absence of disclosure to the contrary implied consistency in application of accounting principles from year to year. Fundamentally, therefore, our position in Canada does not differ from that in the United States.

The American Institute of Certified Public Accountants includes in the introduction to its bulletins a statement to the following effect:

> "Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of opinions reached by the committee rests upon their general acceptability. The committee recognizes that in extraordinary cases fair presentation and justice to all parties at interest may require exceptional treatment. But the burden of justifying departure from accepted procedures, to the extent that they are evidenced in committee opinions, must be assumed by those who adopt another treatment."

The preface to the bulletins of the C.I.C.A. Committee on Accounting and Auditing Research contains a paragraph set out below, which is essentially similar in meaning to that quoted above from the introduction to the bulletins of The American Institute of Certified Public Accountants:

> "In issuing such bulletins, the committee recognizes that no rule of general application can be phrased to suit all circumstances or combination of circumstances that may arise, nor is there any substitute for the exercise of professional judgment in the determination of what constitutes truthful presentation in a particular case."

While the American Institute has stated that the authority of opinions rests upon their general acceptability, it is nevertheless the case that their bulletins have been generally adopted by the profession in the United States. Undoubtedly the acceptance of the principles laid down in their accounting bulletins has been assisted materially by the stand taken by the Securities and Exchange Commission. In Canada it seems likely that the requirements as to financial disclosure of the Securities Commissions of the various provinces will promote substantial compliance with the research bulletins of the C.I.C.A. In the foreword to the recommendations on accounting principles issued by the Institute of Chartered Accountants in England and Wales, it is stated that they are intended to provide some authoritative guidance to members; it would appear that generally the recommendations have been regarded as a guide and have not carried quite the same authority in the United Kingdom as has been the case in the United States. Canada, as frequently happens, stands somewhere between the United Kingdom position and that existing in the United States.

While it would seem fair to say that in Canada the C.I.C.A. research bulletins cannot be considered to have the force of "law", at the same time the practitioner must face the fact that, if he ignores the requirements of the bulletins, he must be prepared to justify his course of action and unless he has sound grounds for the deviation he may well be subjecting himself to considerable peril in the conduct of his professional practice.

THE ACCOUNTANT'S INFLUENCE IN THE FUTURE

EARLY IN October, the Institute of Chartered Accountants in England and Wales held their 23rd fall meeting which was the subject of a commentary in *The Economist,* a British publication recognized as one of the most respected in the world. Those who spoke at the meeting on the future of the profession did considerable crystal gazing and came up with what *The Economist* termed "a welcome awareness of professional responsibility in an age of commercial and industrial change".

In quoting an extract from the editorial, we feel that readers of *The Canadian Chartered Accountant* will be particularly interested in the following comments on the profession's growing responsibilities, representing, as they do, the viewpoint of an intelligent and independent observer:

> "Academic university education has a part to play, but the real basis must be experience on the job. Most will agree that the office of a practising accountant, with the wide variety of work which is usually available and the personal guidance of a partner or senior clerk, should provide the greater part of the practical experience. But are not some changes becoming desirable even in this excellent discipline? One in three of the articled clerks goes into industry soon after qualifying, yet he does so after working through a curriculum largely geared to the requirements of the practising accountant. Practical training there must be, but ought the theoretical work to be done by correspondence course and midnight oil? How long must the practising side of the profession be expected to carry the whole burden of training – and the cost too – when the finished product so often leaves to take an industrial post shortly after qualifying?
>
> "Accountants of 50 years ago would not recognize the profession today. Auditing, it is true, remains the staple of most practices but the emphasis of the audit is changing from routine

verifications and the detection of minor defalcations to a broader approach designed to secure an adequate system of internal check, to verify stock with greater attention, and to prevent misrepresentation. Apart from auditing, the provision of management services – not to speak of tax advice – opens an expanding new field to the professional accountant. Management work has special attractions for many practising accountants who have come to feel an understandable frustration with the negative work of auditing the books of a business community which has reasonably high standards of commercial probity and which yields, in consequence, an indifferent bag of frauds or misrepresentations. It is work, too, for which properly trained advisers are particularly suitable because of the variety of their experience and their intimate knowledge of their clients' affairs. The industrialist with medium-sized interests especially needs expert advice so that the efficiency of his accounting procedures can match that of his production methods."

There is every evidence that the profession in Canada also faces the task of satisfying itself that its students and members are receiving the training and experience necessary to provide the services expected of them. This will be an enduring problem for it is only by the continual appraisal of our training methods and aims that the profession can be sure of keeping abreast of the demands that will be made upon it.

Christmas 1958

Fail not to call to mind, in the course
of the twenty-fifth of this month,
that the Divinest Heart that ever
walked the earth was born on that
day; and then smile and enjoy
yourselves for the rest of it; for
mirth is also of Heaven's making.

Leigh Hunt

Internal Control in a Small Company

WILLIAM A. BRADSHAW

"The basic consideration in the success or failure of a business is the owner's ability, on a continuing basis, to make wise decisions compatible with the economic times, to buy wisely, to sell only as much as he can afford to sell and grow with his business." One of the main characteristics of good internal control is accurate reporting, that is, reporting which is free from innocent or careless errors and also free from deliberate misrepresentations. Accurate reporting is essential if the owner is to be in a position to make the wise decisions referred to in an article "A Look at Commercial Failures in Canada" by John G. W. Shave which appeared in *The Canadian Chartered Accountant,* February 1958.

Many of the principles and practices of internal control have been developed in the past 50 years to meet the problems of large companies. There are techniques for exercising internal control which are available to large companies through widespread division of duties and responsibilities but are not appropriate for small companies. It is interesting to note, however, that some of the techniques which large companies have developed to provide effective control can also be applied to small companies. The small companies of today can develop better internal control than was thought possible half a century ago.

Definition of the Small Company

For the purposes of this discussion, the small company cannot be defined in terms of sales volume or size of payroll. Internal control in the small company depends largely upon the owner-manager being familiar with the business, supervising it personally, and carrying out certain control functions which will be discussed later. If a company has a purchasing department, a credit department, a full-time cashier, or a paymaster, it is not small for the purpose of internal control in that particular phase of its operation. The medium-size company may have small company problems of control in one or more departments, and the large company may have similar problems of control in its branches. Sole proprietorships, partnerships, associations, church organizations and union locals all have similar problems of internal control.

Internal Control: Management Tool

The greatest obstacle to adequate control in small companies is the difficulty many owners have in under-

standing the need for it. Changes of any kind are frequently looked upon with suspicion, especially those which may initially involve more work or increased costs. In order to appreciate some of the benefits, it is helpful to look at internal control in the broadest sense of the word. The broad objectives as set down by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants in 1947 include the safeguarding of assets, checking of the accuracy and reliability of the accounting data, promotion of operational efficiency and the encouragement of adherence to prescribed managerial policies. If the owner is able to decide on sound policies to promote sales and provide capital and technical knowledge, the success of the enterprise should be assured.

A satisfactory system of internal control in this broadest sense means that there is up-to-date accounting and statistical information on which to base decisions. It also means that there are reports which will show the effect of various changes in management policy and reports which highlight those phases of the operation which require attention. It means adequate accounting control over cash, receivables, inventories, plant and equipment, sales, purchases, payrolls, etc. The physical safeguards over all assets are appropriate and the insurance coverage is sufficient to provide full indemnity in case of loss through fire, theft, or employee dishonesty.

Internal Control is Quality Control

The managers of all successful companies, whether large or small, recognize the importance of quality control. The large company will have rigid product specifications, a full-time inspection department, and elaborate testing instruments. The small company, however, can often build up a reputation for unparalleled quality because the owner-manager is so familiar with his products, machinery, employees and customers. The quality of his product or service is a matter of personal pride and quality control is of utmost importance to him.

Internal control can be looked upon as quality control over the products of the accounting department. When clerical errors or embezzlements occur and go undetected, the quality of the accounting reports and effectiveness of management both likely suffer.

Method of Evaluation

One method of making a systematic survey of internal control is by use of a standard questionnaire. Such a questionnaire provides some assurance that no important phase will be completely overlooked and when it has been adapted and expanded to meet the particular circumstances of the company under review, can be extremely useful. For example, such a questionnaire should deal with the following procedures which are feasible in any size of company: use of pre-numbered cheques which must be accounted for, regular and prompt bank reconciliations, use of a cheque protector, regular balancing of the general ledger and all subsidiary records, payment of employees by cheque, prompt deposit of all cheques and cash, use of petty cash imprest fund, etc. Further measures covered by such a questionnaire are also possible in any size company; however, in the case of the small company, the owner-manager should be directly involved. The adoption of these measures would require that he open the incoming mail, approve all vouchers

for payment, cancelling them to prevent their re-use, approve bad debt write-offs and credit notes, sign all cheques, receive bank statements and cancelled cheques direct from the bank, review customers' statements before mailing, review accounts receivable aging, attend stocktaking, review the inventory records, etc.

Internal Control and Fraud

Many of the procedures and routines referred to have one main objective — the prevention and detection of fraud. Untold millions are embezzled by employees each year. These employees — including truck drivers, shippers, cashiers, accountants and presidents — steal cash or any asset which can be converted into cash. The businessman can do three things to protect himself from the "trusted thief". He can see that his system of internal control is adequate; he can have a well recommended and conscientious auditor; he can carry a blanket fidelity bond with adequate limits. If the internal control is not adequate, the auditor may not be able to uncover certain types of fraud no matter how much checking he undertakes. The auditor, as an expert in accounting matters with experience gained from many different companies, can be of real service in advising what action should be taken.

The auditor cannot, however, guarantee to discover all defalcations. If there is collusion or a carefully planned defalcation, the auditor has little hope of discovering it as a result of the usual test examination which is made primarily for the purpose of expressing an opinion on the financial statements. More defalcations are discovered through fortuitous events which defy classification than in any other way.

Blanket dishonesty insurance of the broadest form is relatively inexpensive, and is very important to any businessman who wants to be sure that his investment is adequately protected. It is estimated that even insured employers collect, on an average, only 20% of their total losses, thus producing under-insurance of 80%.

Statistics are difficult to obtain because of the large number of losses which are not reported, not to mention those which are never detected. The most conservative estimate of the amount of money and property stolen by dishonest employees in the United States during 1956 is $500 million, or about $60 million more than the amount which the burglars, pick-pockets, armed robbers and automobile thieves stole in the same period. The employee is more proficient at crime than the criminal. His advantage is, of course, that he is trusted by his employer, his friends, and all those who know him.

The Embezzler—an Average Citizen

To appreciate the dangers of employee dishonesty it is necessary to understand how an embezzler's mind works. He does not think of himself as a thief and will not admit to himself that he is ever stealing; in fact, he lives in two worlds. In his one world he carries on a model life at home, in the community and at work. The typical defaulter has had one or more job promotions because of his long service and his better-than-average ability. In one study it was found that over 25% held supervisory or executive positions.

In his other world he has a secret problem involving a real or imagined need. This need may be the result of

an expensive illness, gambling losses, or ill-timed investment or extravagant living. To meet this need he decides to "borrow" from his employer, providing, of course, he feels he can do so without being discovered. He may rationalize in various ways. He may feel that he is being underpaid and that his true worth is not appreciated. If the partition between his two worlds breaks down, the embezzler suddenly realizes the implications of what he has done. He may confess, run away or take his own life, but he cannot carry on as before.

Occasionally, the owner of a small business feels justified in "padding" his expense reports or pocketing sundry receipts. He may do this to evade income taxes which is in itself very poor business practice. Almost as important, however, is the bad effect it has on the employees. If the accountant, for example, sees the owner acting in a dishonest manner he may follow the bad example set for him and will certainly find it easier to rationalize his own dishonest conduct.

Stamps May be Just a Beginning

The man who steals a postage stamp from his employer now and then may rationalize his conduct somewhat as follows: "My boss won't miss a stamp with all the money he has and anyway I deserve this little fringe benefit for all the extra effort I have been putting into my job". Suppose that this same employee notices that the cash sales are not adequately controlled. He realizes that there is little or no chance of being detected if he were to steal a few dollars instead of a few stamps. He can rationalize his actions in the same terms as when he stole the stamps. He needs the money, he feels sure he will not be detected, and he has convinced himself that it would not be wrong.

The manager of any company, whether large or small, must recognize his responsibility to himself and to his employees when setting up a system of internal control which will reduce the possibility of employee fraud. The need is the same for all companies; the methods may differ in certain respects. The manager of a small company may not be able to justify elaborate control of postage stamps but he should at least be sure that all purchases of stamps are charged to the appropriate account. The manager of a large company cannot afford to be without more elaborate control. Mr. J. K. Lasser's book entitled "How to Run a Small Business" refers to the case of an officer purloining over $13,000 worth of stamps in a five-year period.

No employer has an employee on his staff whom he does not trust, but trusted employees steal more each year than the professional criminals.

Ten Aspects of Control

The following suggestions, although directed specifically to the owner of the small company, should be of interest to the auditor who has a number of such client companies:

1. A careful review of the reports and statements by the owner is important. These reports, examples of which are presented in Appendix A, must of course be accurately prepared. The owner's knowledge of the business and his expectations of its operating results should mean that much of the information which reaches him is no surprise. When some particular item does appear unusual, he should investigate it thoroughly and call for the assist-

ance of his auditor if he is unable to completely satisfy himself.

2. Good reporting depends to a large degree on a carefully planned chart of accounts. The owner, the accountant, and the auditor should be thoroughly familiar and in complete agreement as to what is to be debited and credited to each account. The auditor can be of real service if he helps his client to draw up a chart of accounts which will meet the requirements of the particular business in terms of the information which will be most useful to the owner. If possible, the original chart should be drawn up to permit later expansion and subdivision on a logical basis so that operating trends can be studied for five and ten year periods.
3. A procedure manual or some form of written memorandum also has an important place. Once the most satisfactory method, in terms of efficiency and control, for doing a particular job has been determined, it should be set down in writing. This is particularly important where control depends upon certain duties being performed by certain people at specified times.
4. There is frequently an application for standard costs in the small company. A properly functioning system of standard costs will provide danger signals when variations from normal occur and also provides one of the most effective methods of internal control over material, labour and overhead.
5. Mechanical devices should be used wherever possible. These include cash registers, time clocks, adding machines, bookkeeping machines, and duplicating equipment, to mention only a few. Such devices should reduce the possibility of clerical error, but cannot be relied upon to prevent fraud.
6. The control over accounts receivable can be improved if the owner reviews the statements before they are mailed. The mailing should then be done under his supervision. If all mail is opened by him or his secretary, who should be independent of the accountant, customer complaints can be thoroughly investigated. As mentioned previously all credit notes, adjustments and bad debts should be scrutinized by the owner.
7. Due recognition should be given to the difficulties surrounding the adequate control of inventories. The owner should make surprise visits to the stockroom and shipping platform. He should test-count some of the more valuable items and account for a section of the pre-numbered shipping memos. He should see that these shipping memos are being made out for all sales including sales of scrap and sales to employees. He should take note of customers or truckers on the premises and pay special attention to customers or employees who carry bags or parcels off the premises.
8. Physical safeguards should be up-to-date and adequate for their purpose. Cash, negotiable instruments, insurance policies, and important books and records, including the accounts receivable ledger, should be kept in a fireproof vault or at least fire-resistant cabinets. Door

locks, fire alarm systems and sprinkler service should also be checked periodically. Insurance coverage should be reviewed with the agent at least annually and periodic appraisals requested when necessary.

9. The owner should take more than just a passing interest in his employees, their relatives and friends. He should be aware of their spending habits and means of recreation. Embezzlements involving collusion with customers or suppliers are very common and extremely difficult to detect. Management may stumble across this type of fraud, but undoubtedly many have gone and are going undetected.
10. The last suggestion is to appoint a highly respected and well recommended auditor. Allow him to determine the scope of his examination, listen to his advice and give careful consideration to his suggestions. Consult him regularly and whenever in doubt.

The Auditor

The auditor of a small company must not forget his responsibility to creditors, tax authorities, and the public generally. If he feels that all income is not being recorded on the books or if he is in doubt about the valuation of certain assets, he must resort to "special auditing techniques". Internal control in a small company, which rests so heavily upon the owner-manager, may not be entirely satisfactory for the protection of third parties. If this is the case, and the auditor cannot thoroughly satisfy himself in all respects, he will not be in a position to report that the statements present fairly the financial position of the company and the results of operations.

Some estimates of business mortality place the percentage of retail outlets which are still in business at the end of their tenth year at 20%, and the number of wholesalers and manufacturers at 25%. About half of the failures can be attributed to inadequate financial management. The small businessman who has an accepted product or service to offer and has organized a good system of internal control, which includes good internal reporting, should have an excellent chance of building his small company into a big company. He will not, however, forget the small company lessons he has learned because they will contribute to his continued success.

Appendix

MANAGEMENT REPORTS

1. Monthly or quarterly cash and operating budgets.
2. Cash and operating statements accompanied by explanations where there are significant variations from the budget.
3. Daily and weekly reports showing bank balances, sales, orders received, purchase commitments, etc.
4. Statements showing operating results by departments, product lines and types of customer.
5. Significant ratios setting out the comparison to ratios of prior periods and those ratios which are published for the industry as a whole.
6. Inventory reports showing a breakdown by types of merchandise, age and rate of turnover. Statistical information showing units purchased, produced, sold and on hand.
7. Accounts receivable analyses, prepared monthly, to show the aging of the accounts, number of days' sales represented and balances due from individual customers.

Partnership Buy-and-Sell Agreements

JOHN L. CARPENTER

AGREEMENTS to purchase partnership interests at the death of one of the principals have become increasingly popular during the past few years. They provide an orderly method whereby the deceased partner's business interest is acquired by his surviving associates without interference from the personal representative and heirs and without the necessity for taking them into the business. These business continuation plans have proved to be an eminently satisfactory means of avoiding liquidation losses, assuring the deceased's family full value for their interest in the business, and enabling the surviving associates to continue their career in it. Finally, the partial or full funding of the obligation to purchase the business interest through the use of life insurance ensures satisfaction of the intentions and the desires of the parties. There is every reason, therefore, to expect increased use of these agreements in the future.

Provisions of Agreement

The agreement is entered into by all the partners and provides that the interest of any partner who dies must be sold to, and purchased by, the surviving partners at a fair and equitable price agreed on and specified in the contract. It is based on present consideration, usually being expressed as the mutual covenants, and is stated to be binding not only upon the parties but also upon their heirs and assigns. Such business insurance agreements are not testamentary in character and are thus not subject to attack as invalid testamentary dispositions. The courts have recognized them as being valid and enforceable, and specific performance may be had in event of a breach thereof.[1]

Most firms have a general partnership agreement covering the organization, conduct and termination of the partnership during the lives of the partners. It is important that its terms harmonize with those of the buy-and-sell agreement. Otherwise, an ambiguity regarding the parties' intentions might arise, in which event the purchase and sale might either not be consummated or be delayed by protracted litigation. Correlation between the two documents may be accomplished either by omitting from the general partnership agreement provisions relating to situations covered by the buy-and-sell agreement,

[1] *Calvert* v. *Willis* (1953), 4 D.L.R. 356; Affmd. (1954), 2 D.L.R. 544.

or by a provision in the buy-and-sell agreement stating that in the event its terms conflict with those of the partnership agreement, the terms of the former shall prevail.

Normally, the only parties to the buy-and-sell agreement will be the partners who are involved. If their wives are not part owners of the business, there is seemingly no legal reason to include them. Some draftsmen prefer, however, from a practical viewpoint, that they should either be parties or consent in some manner to the terms. This could avoid complications which might otherwise arise at the time of the sale. If the services of a trustee are used, the trustee would also be a party.

A partnership firm is generally understood by both businessmen and accountants to be a distinct business entity. There is no legal basis for this, however. In English law, a firm is not a *persona* distinct from the members; it is not a separate legal entity. Instead, it is merely a legal fiction maintained for the limited purpose of reflecting commercial credit. It appears, therefore, that the partnership firm itself is incapable of executing and administering a buy-and-sell agreement providing for retirement of the deceased partner's interest by the partnership. Equally, there is no reason for the partnership as such to be a party to an agreement arranged on a cross-purchase basis among the partners.

Valuation of Business Interests

The valuation of the business interests for the purpose of the agreement is an extremely important consideration. The value in each instance, and the method of setting forth that value, should be determined by the chartered accountant regularly retained by the partnership. It is submitted that the method used should be one that accurately reflects the fair market value of those interests.

Frequently, the value will be expressed in terms of a fixed dollar amount. A fair and reasonable price is established at the execution of the agreement, which is subject to periodic changes by the mutual consent of the parties. The agreement usually calls for revision or confirmation of this value each year, and may provide that the last stipulated price shall prevail in all events.

Wherever it is possible to express the value in terms of a fixed dollar amount, the agreement will probably be more readily understood by the contracting parties. The main disadvantage, of course, is that the parties may fail to revalue periodically, resulting in a wholly inadequate value at the time of sale because of fluctuation of values in the interval. In order to avoid this hazard the agreement may state that if the last agreed-upon price was established more than, say, two years from the date of death of a partner, the price shall either be determined by some method of appraisal set forth in the agreement or that the stipulated value shall be adjusted to reflect any net change in the book value (and goodwill, if desired) of the deceased partner's interest between the date on which the agreed value was set and the date of his death. This latter method will not only protect against failure to revise the stated amount, but will assure the deceased's estate of his share of current earnings.

There are factual situations in which the fixed value method will be impractical. For instance, wide fluc-

tuations in inventory during the year, in businesses where inventory is a substantial factor, would make it extremely difficult to represent the true value of the business interests by way of a fixed dollar amount at any time during the year. In such situations the use of one of the customary recognized formulas would be preferable.

One formula which is frequently used requires the value of the partner's interest to be based on book value as determined from the financial statement furnished to the firm by their auditor, or determined by their auditor as at a date stipulated in the agreement. Despite the very extensive use of the book value formula in buy-and-sell agreements, no definition has universal acceptance. The drafting of a book value provision, therefore, requires caution, since the meaning of book value may often be a question of legal interpretation dependent upon the parties' intent rather than on accounting definition. Questions or disputes may arise as to whether book value as a method of valuation was intended to mean literally amounts shown on the ledger accounts or amounts shown after correction for (a) errors, (b) departures from consistently maintained practices of the business, (c) departures from generally accepted accounting principles, or any combination of these or other corrections. The Committee on Terminology of the American Institute of Certified Public Accountants has recently suggested that any agreement involving the general concept of book value should contain a clearly defined understanding in specific and detailed terms. This would be a wise precaution.

In any event, before a book value clause is written into a buy-and-sell agreement, the firm's auditor should be consulted. He will determine whether the records are kept in such form that the book value thereby established is reasonable and accords with the general notions of the contracting parties.

Necessary Factors

If the book value method is to be used, the valuation clause should contain all the necessary factors. Specific reference may be made to such items as the following:

1. *Inventory* – Inventories should be based on actual physical counts. When they are carried on the books at cost, values should be checked to see if they represent the real worth. In those instances where inventories are valued at the lower of cost and market, it may be desirable to define the terms "cost" and "market" in the agreement.
2. *Real estate fixtures and equipment* –If the depreciated book value does not reflect current market value, the agreement may provide that these tangible assets are to be valued by independent appraisal.
3. *Accounts receivable* – What percentage of possible losses is not reflected in the book value? Should the accounts receivable be determined by appraisal or otherwise valued?
4. *Marketable securities* – They should be valued at market price with or without regard for commission and other disposal expenses.
5. *Determination date* – If book value is shown by the financial statement for the end of the pre-

ceding year, six months or quarter, is it intended that the share of profits or losses of the deceased partner for the subsequent interval be included or excluded in the purchase price? Book value as at the date of death in some instances is almost impossible to determine because of the problem of inventory.

Provision should be made, of course, for periodic review of the book value clause.

Valuation of Goodwill

The book value method does not include any valuation for goodwill, except in the unusual case in which this item appears in the balance sheet. The method may be deficient in a given case, therefore, because it may not set the purchase price of the deceased partner's interest at a figure that will reflect the actual going-concern value of the business. Where large amounts are involved, substantial injustice may thereby be done to the deceased's estate.

Some lawyers follow the practice of incorporating a formula based on the capitalized value of goodwill plus book value. For example, a formula might stipulate that the net earnings, averaged over a specified period, such as five years, be computed. From the average net annual earnings may be deducted a specified percentage of book value, such as 10%, as earnings on invested capital, and a specified amount as equivalent to compensation for the personal services of the partners. The balance of the average net earnings, after the deductions just described, may then be capitalized at a prescribed rate to ascertain the goodwill value to be added to the book value in arriving at the full purchase price.

Another formula calls for the straight capitalization of the average net profits at a definite rate, the result being taken as the total value of the partnership, including goodwill. This plan is flexible, since a capitalization percentage may be selected by the partners to approximate most closely what they believe to be the value of their interests. To illustrate, such a formula might require that the net profits be averaged for the last five complete fiscal years prior to the death of the partner and then capitalized at, say, 10% to obtain the total value. Assume that the average net profits for the last five years have been $20,000. Capitalizing this amount at 10% gives a total of $200,000 from which the purchase price for each partner's interest may then be easily calculated.

Often the agreement will establish the amount of insurance proceeds payable at the death of a partner as the minimum purchase price for his interest. While such a provision may seem advantageous because it enables each partner to know the minimum amount his estate and heirs will receive, it can work a hardship on the surviving partners if the actual value of the deceased's interest has declined. Moreover, the partners are deprived of the financial cushion which may be needed to give stability to the business operations of the firm.

Life Insurance Coverage

Since a business continuation plan will be successful only if the money is available at the required time to implement the purchase and sale provisions of the buy-and-sell agreement, steps must be taken at the time the agreement is prepared to ensure availability of the necessary funds. Borrowing the purchase price, paying

it on the instalment basis, or building it up out of personal savings have all proven to be costly and usually ineffective. Life insurance owned by each partner on the life of each of the others in the amount of the purchase price is a sound and practical solution to the financing problem, and is now regarded as the ideal method of prefunding.

The beneficiaries of the insurance policies should be the parties who are obliged to use the proceeds in purchasing the interest of the deceased partner, that is, the partner or partners who are applying for the insurance. It is sometimes suggested that a personal beneficiary of the insured be named in the policy or policies on his life. This is not recommended. In the absence of very careful draftsmanship, this arrangement could void the agreement, because it leaves the beneficiary named in the policy in possession of the insurance proceeds and the deceased's estate entitled as well to his interest in the business.

Payment of Premiums

The policy owner in each case will pay the premiums. If there are only two partners, each pays the premiums for the insurance on the life of the other. If there are three or more partners, each will buy insurance on the life of each of the other partners in an amount equal to the value of the business interest he is to acquire in the event of the latter's death, and will pay premiums accordingly.

For convenience, simplicity or other reasons, other methods of premium payments are sometimes suggested. These include having the premiums paid by the insured himself, or by the firm, or from a pool. The "pooled method" is sometimes used where there is a substantial difference in the ages of the partners. Under it, each partner may be charged with that part of the premiums for the insurance on his own life, as well as that part of the premiums for the insurance on the other lives equal to the percentage of his interest in the firm.

It seems illogical for the insured to pay premiums on the policy that furnishes the proceeds for the purchase of his interest in the business. This not only results in his partially financing the purchase of his own business interest, but also may create a succession duty complication. The tax authorities may attempt to include a portion of the policy proceeds as well as the value of the business interest in the deceased's estate for succession duty purposes. If the firm is to pay the premiums, the account of each partner may be charged with the premiums attributable to the policies he owns on the lives of his co-partners. In all events, both economics and commonsense would seem to indicate that any loss to be suffered in the payment of premiums should be borne by the partners in relation to the actuarial chances of their benefiting respectively.

Restrictions on Policies

In order to better ensure performance of the agreement, the policy owners should be prohibited from exercising their ownership rights in and to the policy contracts without notice to the other partners or without their consent. This restriction prevents the policies from being encumbered or terminated, which would endanger the practical performance of the purchase and sale.

Provision should be made for dis-

position of the insurance policies owned by the deceased partner on the lives of the survivors. The ownership or control clauses of such policies will normally provide that ownership vests in the owner's estate on his death. When partners fund a buy-and-sell agreement with insurance, they forego the use of the premium money in exchange for the guarantee that a larger sum will be available to buy out their interests on death. To the extent these premiums have built up a cash value in the policies during lifetime, the deceased partner's estate is entitled to receive his share of this asset upon his death. The surviving partners may be given an option to purchase such policies at their cash value, or for an amount equal to the interpolated terminal reserve plus the unearned premium calculated as of the date the option is exercised. If the option is not exercised by the survivors, the estate of the deceased partner may surrender the policies for this cash value.

The survivors' contractual right to the policies on their lives owned by the deceased's estate is a valuable privilege. It gives them insurance at a lower premium rate than they could purchase at their respective attained ages, and, of course, they could be uninsurable in which event they could not purchase protection at any cost. Moreover, in the absence of such prior agreement, the survivors could not compel the deceased's estate to turn over the insurance policies to them, even if they offered to pay the current cash value or back premiums. The disposition of the policies is a matter of significant importance to all the contracting partners. Care should be taken, therefore, to see that it is not overlooked in preparing the agreement.

Uninsurable Partner

In arranging for the insurance to fund the plan, one of the partners may be found to be uninsurable. The method most often used in this situation provides that the purchasing partners will contribute to an annual premium retirement annuity contract, an amount approximately equal to the life insurance premiums that would otherwise have been paid. Whatever this sinking fund amounts to on the death of the uninsurable partner may be used as a down payment in purchasing his interest, with the balance payable as specified in the agreement.

As mentioned previously, the purchase is usually on a net basis, the purchaser acquiring the business assets and "going value" and assuming the outstanding liabilities and obligations. The estate in return is released and indemnified by the surviving partners. There may be liabilities of the partnership other than those shown on the partnership books, and it may be desired to make specific reference to such items in the agreement. Provision in the agreement alone, however, cannot ensure protection, and additional security may be required, either by way of a bond of indemnity or the holding of the life insurance policies on the lives of the survivors for a stipulated period of time.

Use of Trustee

The parties may desire to use a trustee to ensure performance of their reciprocal obligations. It is generally considered of great value to have an impartial party to supervise performance of such an important contractual undertaking, and in whom both the deceased's estate and the

purchasing partners may have confidence if questions or disputes arise. The more usual arrangement is to name the trustee beneficiary of the life insurance policies being used to fund the agreement. In this event the agreement conventionally provides that upon the death of a partner, the trustee will collect the insurance proceeds and pay them over to the deceased's estate. In exchange, the executors assign the deceased partner's interest in the partnership to the surviving partners. The rights and obligations of the trustee should be clearly defined, of course.

There should be no adverse tax consequences on the sale of a deceased partner's interest at his death under the conventional cross-purchase arrangement. It is clear that the proceeds of sale of a partnership interest are return of capital in the hands of the vendor.[2] The insurance policy premiums paid by or charged to each partner do not constitute a deductible item for income tax purposes, regardless of how the premium costs are distributed among the partners. Offsetting this, and of far greater importance to each partner and his family, is the fact that the insurance proceeds are not subject to income tax when the partner dies.

Effect of Succession Duties

The value of each partner's interest for succession duty purposes is its fair market value at the time of the partner's death. This value which takes into account the goodwill, if any, is the true value of the deceased partner's interest and not necessarily that at which the surviving partners have power to take it over. Production of a balance sheet may be required by the tax authorities in order to prove the accuracy of the valuation. In this connection, section 3(6) of the Canadian Succession Duty Act must be kept in mind. Under its provisions, where property is transferred or acquired on or after death for an amount less than its fair market value under the terms of an agreement made by the deceased at any time, the difference between the value of the property and its price is deemed to be a succession. Thus, if the buy-and-sell agreement calls for a price less than the true market value of the interest, the surviving partners will be deemed to be successors to the extent of the difference, and will be liable to pay succession duty on it. The use of a method of valuation which accurately reflects the fair market value of each partner's share for the purposes of the agreement is, therefore, in the best interests of all concerned.

In addition, the deceased's estate becomes the owner of the values of the policies which the deceased owned on each surviving partner's life. These values would also constitute an asset of the deceased's estate for succession duty purposes.

Many other provisions may be indicated in the agreement to be prepared in a given case. It is hoped that this discussion will be useful in pointing out to those not too familiar with the workings of the buy-and-sell agreement the principal factors to be considered in its preparation.

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[2] This accords with the long established principle, that that which is paid to a person to give up a right is a capital sum. See *National Paving Co. Ltd.* v. *M.N.R.* (1955), C.T.C. 353. See also *No. 315*, 14 Tax A.B.C. 311; *No. 408*, 16 Tax A.B.C. 417 and authorities therein referred to.

The Use of Break - Even Analyses in Management

BRUCE C. WILLIS

ONE OF THE most useful techniques available to modern management is a well conceived system of budgetary control. To be of maximum value, a budgetary control system should incorporate flexible features and be readily adaptable to changing conditions. Its development will involve a careful determination of fixed, semivariable and variable expenses, from which will be derived the basic data required for understanding effectively the inter-relationship existing between profit, cost and volume.

The object of this paper is to emphasize that additional advantages are obtainable from the further use of the data required for the budget in developing break-even analyses. Such analyses represent more than the mere determination of the volume level at which revenue equals cost. Rather, they expose the effect on profits resulting from the interplay of such factors as prices, costs, volume, product mix and inventory levels.

While prices must bear a reasonable relationship to costs, they also influence the volume of sales, which in turn, affects inventory levels, production requirements and various elements of cost. Very few enterprises can sell on a strict cost-plus basis. In the normal competitive market, prices must be related to customer demand and competition. In general, selling prices do not have a rigid relationship to costs, but over the long term all costs, together with a reasonable profit, must be recovered if a business is to be successful. When considering the most advantageous pricing for its products, a company must regard both volume and cost as variable. The lower the price the greater the customer acceptance, which in turn increases volume, reduces costs and makes lower selling prices possible.

Behaviour of Costs

In developing break-even analyses it is essential to have a clear understanding of the behaviour of costs. Costs are often classified into two main categories — those which relate to productivity or volume, and those which relate to a period or the passage of time. Segregation of costs in these two areas will determine broadly whether costs and expenses are variable or fixed in relation to production. While the principle of classifying costs as fixed and variable is theoretically simple, in practice there are a great many costs which do not fit either group and must be classified as semi-variable or semi-fixed.

Truly variable costs will vary in proportion to production or activity: with no activity the costs will disappear; if activity doubles the costs will double. For example, material costs are normally in this variable category. Semi-variable or semi-fixed costs increase or decrease as production or activity increases or decreases but not directly in proportion. Indirect labour falls within this group. Fixed costs remain constant for a given period of time regardless of volume and ordinarily would include costs related to fixed assets and certain types of administrative expense, such as salaries.

However, cost behaviour is not the same under all conditions and the elements of cost will vary with factors other than volume. Fixed costs may not remain fixed at all volume levels and not all variable costs vary proportionately with volume. Indeed both fixed and variable elements of cost are often dependent on policies laid down by management, policies which are subject to change.

Exceptional Factors

In addition, break-even analyses must take into consideration a number of exceptional factors pertaining to volume, inventory levels, product mix and other factors, of which the following are examples:

1. Rapid changes in volume may change the normal behaviour of variable costs. Management may well be unable at short notice to adjust the labour force to current requirements in times of rapidly changing volumes. In many instances restrictive provisions in union contracts, such as call-in pay and other penalties, make this problem more difficult.
2. As volume increases, some variable unit costs may change their normal behaviour and tend to increase. Excess costs such as learning time for new employees, higher scrap losses and overtime premiums may be encountered. During times of expanding sales rigid cost control is difficult to maintain.
3. Significant changes in inventory levels will change the factors in break-even analysis. While some costs are related to sales, most costs are related to production. Consequently, the impact of increases or decreases in inventory should be considered in the analysis.
4. Product mix and multi-plant operations undoubtedly tend to complicate the basic problems of a break-even analysis. The analysis may be simple where only one plant or one product is involved, but becomes unwieldy when many products or many plants are considered together.

This difficulty can only be overcome with ingenuity. Possibly the best approach is to prepare a break-even calculation for each product group, including appropriate allocation of the fixed costs to the various products. While this allocation may result in break-even calculations by product groups which will not add to a true calculation of the overall corporate break-even point, the data is of significant value.

Although the above comments indicate a degree of complexity and limitation in the preparation and use of break-even data, the widespread use of these analyses attests to their value for management control. Companies of all sizes have found that the development of break-even analyses

provides helpful information for essential decisions.

Margin of Safety

One of the chief advantages of break-even analysis is the development of a knowledge of the margin of safety at "normal", or average, volume over a business cycle. If the break-even volume for an enterprise is too close to the "normal" volume, there is ample evidence that the organization is headed for trouble. The most common reaction to this situation is to claim that fixed costs are excessive. This may not be the case. There are several other causes which could contribute to this situation, such as:

1. Lack of efficient production resulting from inadequate labour control or inefficient machines.
2. Lack of adequate pricing.
3. Lack of effective selling techniques.

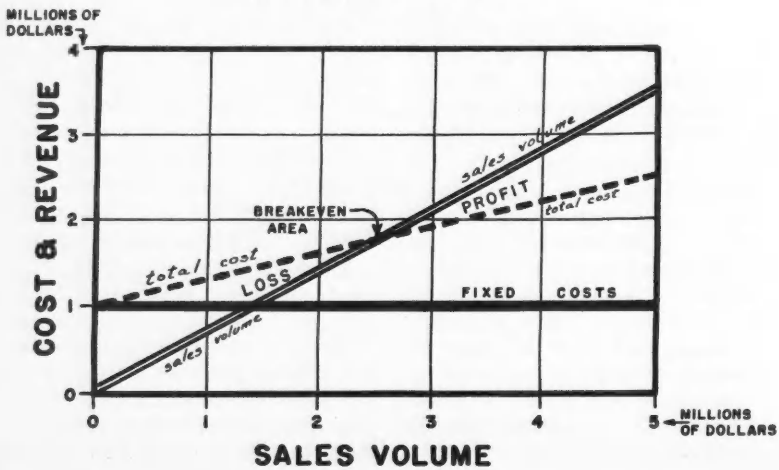
It is equally true that the creation of new fixed costs, such as investment in new plants, may create serious problems unless planning has been done with the help of break-even analysis.

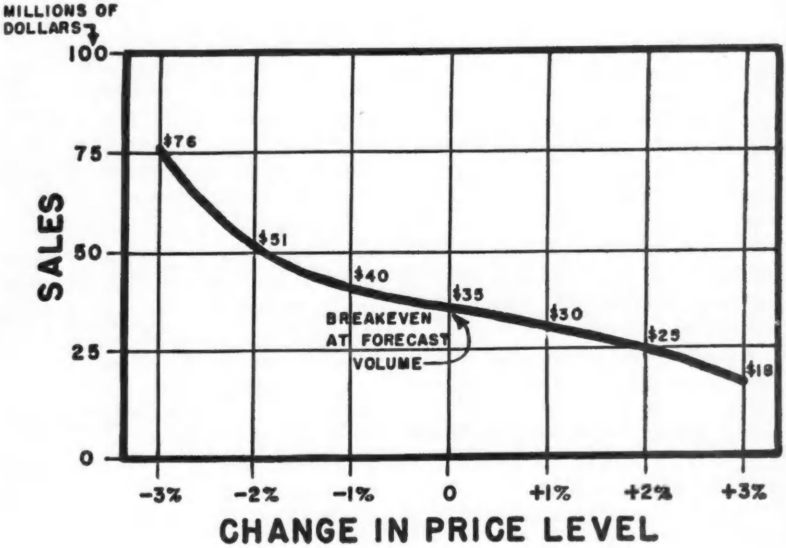
Break-even calculations are conventionally shown in chart form. This reporting technique is extremely useful in simplifying the presentation of problems in the cost-volume-price relationships. The basic presentation form shown below is only one of a number of suitable forms used to illustrate break-even analyses graphically.

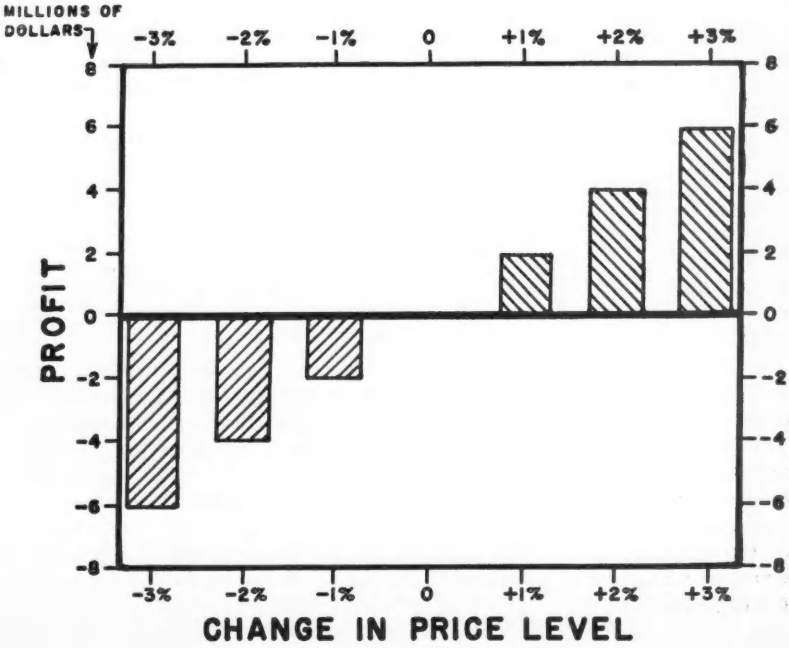
This chart shows a fixed costs line along the lower portion. It is important to realize that such costs are only fixed within a relevant volume range. If volume fluctuates beyond this area, fixed costs, represented by salaried personnel, new plant expenditures and other items, could change materially.

Variable costs are represented by

"ABC" COMPANY
BREAKEVEN CHART




MILLIONS OF DOLLARS
SALES
100
75
50
25
0
$76
$51
$40
$35
$30
$25
$18
BREAKEVEN AT FORECAST VOLUME
-3%
-2%
-1%
0
+1%
+2%
+3%
CHANGE IN PRICE LEVEL


MILLIONS OF DOLLARS
PROFIT
8
6
4
2
0
-2
-4
-6
-8
-3%
-2%
-1%
0
+1%
+2%
+3%
CHANGE IN PRICE LEVEL

the difference between the total-cost line and the fixed-cost line. Sales have been shown by an oblique line rising from zero to maximum volume. The point where the total-cost line cuts the sales line is the break-even point. Warning should be given here that the break-even position is an area, not a point. Because of the number of variable assumptions used in developing such a chart, we cannot pinpoint, exactly to the dollar, where break-even actually occurs.

Many alternative methods of presentation of the basic data developed by break-even analyses can be used advantageously to portray significant facts. For example, if changes in prices are being considered, the charts on page 527 can be used to portray the effects of such changes.

Similarly, the effect of a large variety of circumstances could be illustrated and many other types of charts might be used.

Break-even analyses are frequently criticized for the inherent inaccuracies resulting from relating cost behaviour to volume when many extraneous factors also have an influence on the level of costs. However, with proper understanding and judgment such data need not be exact to be adequate for the purpose of broad management decisions.

Figures used in forward planning cannot be exact. The future is unknown and the elements of cost, prices and volume in a business are subject to continuous change from diverse causes, both within and without the organization. In spite of these facts the forecasting of expected costs and prices at varying levels of production is of great value in choosing the best courses of action to be followed.

The development of break-even analyses and the information on cost and sales provides an education in the operation of any business. This education can be as valuable for the persons involved as the development of the control technique itself.

The Profit Goal

In implementing the management function through accounting, the accountant must believe implicitly in a "profit and loss" economic system. His constant goal must be the guidance of management to an optimum profit. At times this may be a higher profit level than the management feels is justified or attainable and at other times a lower level. At all times the cost level over which this profit is realized must be a minimum consistent with the quality of products or services represented as being offered to the customers of the company. With this goal for the guidance of management, the accountant will serve as a balance wheel as he makes his contacts throughout the organization.

—I. W. Keller in "Management Accounting for Profit Control".

Chartered Accountancy as a Profession

PETER WRIGHT, Q.C.

PROFESSIONS ARE a proper study for today and for this purpose there is no profession more appropriate than that of the chartered accountant. He has come far in such a short time. He has risen to considerable heights. His profession is so directly related to the business civilization which has developed during the lives of living persons. For these and other reasons, the profession of chartered accountancy in Canada today is a sound background for a discussion of professional life and status.

Positive Features

What are the positive features today of this profession in Canada? There seem to be six:

1. Strong connected statutory self-governing Institutes controlling the entry, status and conduct of their members.
2. The use of a privileged designation, "Chartered Accountant" or "C.A.", protected by law.
3. Admission by examination.
4. The student-in-accounts training system.
5. A recognized place in business as the leading practitioners of three skills:
   (a) Supervision of accounting and particularly tax accounting,
   (b) Independent auditing,
   (c) Management services.
6. The exercise of these skills with integrity, independence, judgment and devotion to the client's interest, where and as each is required.

Potential Features

These six features describe what the profession is, but it is of equal interest to list what it is not and might be today in Canada. It is suggested that these potential features are:

1. It is not yet fully conscious of its own strength, growth and future.
2. It is still divided in its view of its function in business and the breadth of the services it should offer.
3. It has not yet developed a regular function in society outside business.
4. It does not require a university degree as a qualification.
5. Its codes of ethics are concerned with the details of misconduct rather than with the principles of good conduct.
6. It does not yet cover all those in its field who profess the same skills.
7. It makes little difference between the practising public accountant and the rest.

These lists of attributes, discerned and potential, raise most of the issues facing the accountancy profession.

A summary of an address given at the Canadian Institute of Chartered Accountants 56th annual conference, Montreal, September 15-17, 1958.

Definitions of a Profession

There are two definitions of a profession today. The one is that of a calling of experts qualified by training. The other, relating more directly to the lawyer, doctor and chartered accountant, is:

> "A self-disciplined group of individuals who hold themselves out to the public as possessing a special skill, derived from training or education and who are prepared to exercise that skill primarily in the interests of others."

If the latter definition is chosen, members of the professions will be able to see more clearly where they are going than if they adopt the definition that professional people are merely "educated experts". The vital element is the last. Each element of the chosen definition is important. The fact that the accounting profession is self-disciplined is accepted and valued. The holding out to the public is what the practising chartered accountant does. The special skills of accounting and auditing are universally professed. They are derived from training and special education.

The sincerity with which the members of a profession believe that they work primarily to help others is at once the mark and bulwark of a true profession.

This is not to say that self-interest need be alien to a profession, but that the one thing that unites its members in their work is that they are applying their knowledge and skill not simply to earn a living but in the service and interest of other people and of society generally. Their decisions in their work are wholly determined by the interests and lives of their clients and not by their own. As groups they should be seeking how to serve not themselves but others better. This is the centre of a profession's common wealth. It is also the reason behind many of its rules of conduct.

This part of the matter is clearly put by John L. Carey in his book "Professional Ethics":

> "No one suggests that a practitioner should pretend that the making of a living is of no interest to him. This would be an artificial pose, and few people would believe it. Nor will he succeed in creating the impression that he is primarily interested in service unless it happens to be true. His first job may be to cultivate his own motivation to service — that is to make it clear to himself, in his own thinking, that he is interested first in doing a good professional job and, secondly, in the compensation. He can do this without any disadvantage to himself or his family, because experience shows that a professional man who does concentrate on service and improving his capacity to serve has little need to be concerned about money. The world will beat a path to his door.
>
> "One way of avoiding the impression that money-making is the primary interest is to avoid behaviour commonly associated with commercial activities, for example, advertising and solicitation, competitive bidding, and the giving and receiving of commissions and brokerage.
>
> "The rules of conduct on these subjects are among the foundations of the professional attitude."

Other Criteria

This idealism is as hard to define as it is easy to doubt and deride. It must be in the heart, not in the mouth. There are other concrete criteria of a profession: its self-disciplined organi-

zation, standard of education and training, and independence.

The individual unit of the accounting profession is the independent public accountant practising alone or in partnership, or employed in practice. On and for such a man, the whole profession depends and exists. The more his position is recognized the stronger and more lasting the profession will be.

The self-disciplined organization, which the Institutes of Chartered Accountants exemplify so well, must be maintained. Self-discipline means what it says. The members of the Institutes must accept the discipline of the Councils. The Councils must deal fairly with their members and must conduct their proceedings in accordance with natural justice. I know of no profession better able to do this, for the first professional function of accountants is just judgment of statements. One of the best ways to remain self-disciplined is to stay away from the courts, just as one of the best ways to stay away from the courts is to be self-disciplined.

There is also the standard of training and education. Here the Institutes have exemplified a faithful devotion to a long course of practical training and arduous examinations. There can now be no other profession so closely related to office training for the fundamental skills. No one need quarrel with this system.

There have been and continue to be changes taking place which affect this question of training and education in different ways. In the first place the chartered accountant is no longer only an auditor and an accountant but he assumes to have skills and knowledge in a much broader field. Secondly, the place of university education in society and the character of university education has changed. It is now almost a minimum qualification for an educated person. By the same token universities provide courses which are designed to give a general educated background to our civilization. Therefore, in the professions which are undertaking a part of the responsibility for the direction and order of human activities today a university education should be a basic requirement.

If chartered accountants are going to continue on the road of being policy advisers to business in a civilization dominated by business they must ensure that their students-in-accounts have a wider education than comes from office work and their present curricula. A broad education is not a monopoly of the universities, but it is most readily available there.

It is important also to cherish those parts of professional life that have to do with people rather than with business. Indeed it might be wise to develop a few skills in this regard. Could not accountants, for example, offer a family a budget and disbursement control service that thousands of families need and hundreds would gladly pay for? Of course, it would be uneconomic and a bore and a peck of trouble, but it would relate accountancy directly to human beings.

Importance of Independence

Finally, there is independence, which marks the accounting profession to a degree not found elsewhere save among judges. The profession is identified by two distinct kinds of independence. First, there is the absolute independence of the auditor and, secondly, the fraternal independence which all men share who believe that they are their own masters, are self-reliant and subordinate to no one.

The lawyer and the doctor gladly share this second kind of independence with public accountants. All three must strive to retain it, surrendering this individual freedom in their work neither to the state nor to their clients. When and if it goes, much of the meaning and brotherhood of professional life will go with it, and the free elements in society will be sadly weakened.

Although chartered accountants hold to this kind of independence in all their professional work, the standard of independence they profess in the examination and certification of financial statements is much more exacting. Their attitude towards this higher standard of independence will do much to determine the future of their profession just as it now fires some of their warmest controversies.

The first aim, with regard to this standard, should be to keep it pure and absolute. Like the judge, chartered accountants should not only be impartial but appear to be impartial. There is a great temptation and tendency among professional people to conclude that a profession confers a sum of grace on members. They consider that they are so high-minded, and their ethics so strong, that they can properly act on both sides of a transaction, or cast the impartial eye of an auditor on what they have done as a director or an accountant. Of course, this is true to a degree and as a practical matter in little affairs, but in any matter of moment and in principle, it destroys the basis of a professional life. If it is once allowed that a lawyer can act in one matter for two opposing clients or that an auditor can give an independent opinion on his own books, it is admitted that the essential feature of each is not so important and that all that is needed is a kind of skilled integrity in both.

The lawyer is not given his privileges to administer justice fairly to all men; he is there to serve his client. Auditors have no proper role unless their opinion is truly independent and accepted as such. They should ensure that in this part of their work there can be no basis for any charge of partiality. When concerned with policy as director or adviser, they should not, in any matter of significance, certify as auditor the results of their own direction or advice.

The preservation of this position should continue to be the first concern of the profession. The independent certificate is its hallmark.

This is not to say that activities as advisers on accountancy and business practices, or as advocates in tax and administrative matters, need be abandoned. It does mean that if there is the slightest danger to the independence of the opinion, another auditor should be called on to discharge that responsibility. The more jealously the profession guards the integrity of its certificates the more securely it will continue to command the respect which has brought it so far in a short time.

If professional people choose their course from ignoble motives and material considerations they will not only tarnish and destroy the honourable professions they have inherited but will help to lead society in the wrong paths.

If, on the other hand, their lives are moved according to the unselfish, conscientious, generous, learned and independent traditions which are the things that the true professions hold in common, they will to that extent discharge the professional responsibilities which they have undertaken.

THE SMALL STORE:

Sales and Credit Problems

THOMAS. H. SHEPHERD

THE INFORMATION disclosed by intelligently designed sales records is one of the most important aids to the successful management of a retail store. Consequently the way in which sales are entered and analyzed must be planned carefully. However, adequate figures on sales are not enough. Effective methods must be followed to collect the amounts due, or losses from bad debts can nullify other efforts and even cripple the enterprise.

Sales Records

The nature of the business of a store will determine the type of original sales record which is the most practical. If the sales are many and the amounts small, such as in a drug or confectionery store, the record of each sale need not be as extensive as in a store where sales are fewer and larger, such as in a furniture or jewelry store. Cash register tapes supported by a daily cash and sales summary might be adequate in the former, whereas detailed written records of each sale would be more desirable in the latter. When charge sales are involved it is important to obtain the customer's signature, if possible, on the invoice for each such sale or on a delivery slip; but this practice may not be necessary if the customers are known to the storekeeper or otherwise accredited. Sales invoices are usually supplied at the time of sale from a counter sales book, multiple invoice record, or possibly a modern punched card processing machine. In some instances, invoices may be typed after the sale and mailed to customers. In any case, the nature of the records should make provision for an analysis of sales which will be most helpful to the proprietor or management.

Sales Analysis

Sales should be analyzed in dollars in such a way as to give data which is the most pertinent and useful in assessing past performance and planning new policies. Usually sales figures are classified into types of goods, or departments, or both; and often it is helpful to have further breakdowns such as between cash and credit sales, advertised and non-advertised lines, marked-down specials and normal margin sales, daytime and evening business, and the like. Sometimes it is helpful also to analyze sales by quantities to reveal trends of physical volume, average prices received, data for buying policies, or figures for inventory controls.

For instance, the owner of a paint and wallpaper store did not realize that his sales of high quality paint were declining in quantity because

steadily rising prices had kept the dollar total fairly steady. When he analyzed his paint sales by grades and quantity, the trend became apparent. By altering his paint display and accenting quality when selling, he was able to increase greatly the sale of the high grade (and high margin) products with a consequent increase in profits. The same storekeeper had little available room to display related tools, brushes, spreaders and decorative specialties. His sales analysis revealed the uncultivated volume and profit available from these goods and indicated an attractive potential if more display space could be found. By moving his office into the basement and converting the former office area into additional selling space for these goods, he further expanded his net profits considerably.

Sales analyses must be supplemented by comparisons with related figures if a full understanding of them is to be gained. Usually this is done in retail stores on a calendar month or 4-week basis, comparing the current figures with those of similar months or periods in the preceding years. For further comparison, sometimes average sales trends and profit margins in the trade can be obtained currently from trade associations or the Dominion Bureau of Statistics. These comparisons should be studied carefully to determine in what respect the figures of the individual store are different from the average of others, as this may indicate areas in which the store is inefficient or incurring unnecessarily high costs.

The multiple invoice plan for record keeping is coming into wider popularity where adaptable, as it will eliminate the making of many entries. A number of copies of the original record of a sale are produced at one writing by means of carbon on paper of different colours, appropriately printed in each case. For example, a retail store handling mostly charge and some cash sales might use the following copies:

1. Invoice copy to customer (original – *white*).
2. Chronological record of sales (*green*), kept in numerial order to permit the totalling, and analyzing of sales and back reference.
3. Accounts receivable record (*buff*), placed in a file maintained for each charge customer, and removed and marked when paid. In the case of cash sales, this copy is so marked and attached to the daily cash report.
4. Statement slip (*blue*), also kept in customers' accounts receivable files and if unpaid sent to them at the beginning of each month with a listing indicated to be a statement of outstanding items for the previous month.
5. Salesmen's copy (*yellow*), used for reporting to salesmen their monthly sales and commissions.

The use of the above copies would eliminate the need for an accounts receivable ledger, the monthly preparation of a detailed statement of account to customers and a detailed salesmen's statement. In multiple invoice systems, careful filing procedures become of paramount importance, as otherwise the records may become difficult to balance and accounts receivable may be overlooked.

Sales Costing

The alert storekeeper is always watching for methods of improving his gross margin. To do this effectively, he should be continually aware of what current margin he is realizing from his various lines or de-

partments. The original mark-up over cost may not give a reliable indication of the gross profit obtained due to subsequent mark-downs, bargain sales, allowances for shopworn goods, disappearances and the like. One method of checking on realized margins is to take frequent physical inventories, and to use them in the preparation of interim financial statements. Another method which will give the margins whenever wanted is to show the cost of the sales tag. This plan is appropriate in many cases, but usually only when the average article sells for more than $5.00.

Under this scheme a code is used to prevent customers from determining the costs. A very simple code might be somewhat as follows:

M – 1	S – 7
N – 2	T – 8
O – 3	U – 9
P – 4	V – 0
Q – 5	W – *spiff*
R – 6	

Other letters have no significance and may be used as a blind. For example, KSRN would mean $7.62. Sometimes a commencing letter such as A, B, C, or D might be used to indicate the department, class of goods involved or other required classification. The *spiff* indicates an article which the store is pushing because of its high margin or the need to reduce the stock of it, and on which a small bonus is paid to the sales clerk who sells it. The cost code is written on the sales tag attached to each piece of merchandise as soon as the goods have been received and the cost and selling price determined. The cost should be calculated to include the invoice price, freight and other laid down costs. When the sale is made, the code letters are copied from the tag on to the duplicate of the sales invoice or other record, from which they are interpreted, classified and added as part of the office routine. Of course, codes and methods differ between stores and each store owner should work out a plan most suitable to his own business. Besides providing accurate cost of sales and margin figures, the totals may be used to maintain book inventory controls by classes or departments, often eliminating the need to keep individual inventory records.

Punched Cards

The use of punched cards for producing records for medium to large retail stores is very effective in some circumstances, particularly if a punched card service centre is near at hand. The best application is when a store has a large number of sales, the goods are almost entirely of standard repetitive lines and may be readily displayed on counters and stands, and the benefits of staff reduction and the information produced will more than offset the cost. A good example might be a store in a large city selling automotive supplies, accessories and hardware. On the display of each article is a box of prepunched cards relating to the article, and the customer or a clerk removes a card from the box for each article which is being purchased. Immediate processing of the card through a machine kept in the store will produce an invoice for the customer and accumulate totals. However, further machine processing of the cards will produce almost any desired analysis of sales, cash sheets, inventory records and the like.

The use of margin punched cards capable of being needle sorted will produce a great variety of sales analyses if desired, but is usually ap-

propriate only if the average article being sold exceeds $10.

Customers' Accounts

The nature of customers' accounts for charge sales will determine the most suitable records to use. These can be in the form of ledger sheets or cards, multiple invoice copies as previously described, or statements of account kept in duplicate. Usually statements of account are mailed to customers monthly, although this may be omitted if the outstanding balance has been paid. In the larger stores, statements of account may be sent out on a staggered or cyclical basis to spread out the office routine.

One method of credit financing that appears to be gaining in popularity is what is known as the revolving credit plan. Basically, this is a method whereby a person making credit purchases does not have to make payment within the usual 30-day period, but pays a certain predetermined amount each month. For example, a person who calculated he could pay $15 a month regularly from his income could establish a credit of say $120. He would then be allowed no further credit until he had made his first payment of $15, and would then be allowed a further $15 credit to achieve the predetermined maximum of $120; or if he made four monthly payments without any further purchases in the interim, he would have a balance of $60 to use before reaching his maximum credit. One advantage of this system is that it stimulates sales, as individuals are more inclined to purchase an article if they know they can spread the payments over a certain period, and can budget accordingly. It is of benefit in the collection of accounts as customers will be more likely to keep their payments regular, knowing that they will be establishing a further credit for future purchases. It should be noted that a small service charge may be made monthly on revolving credit plans.

The following forms of sales, apart from cash sales, may be found in the most frequent use in retail stores:

1. 30-day charge.
2. Instalment payments.
3. Deferred payment.
4. Revolving credit.
5. Lay-a-way.
6. On approval.
7. Christmas club.

The keeping of records for these various types should present no serious difficulties. For instalment payments, the sales entry should indicate the carrying charge so that it may be properly recorded in an appropriate account in the general ledger, and the entry charging the customer should show the number of instalments involved and enough particulars so that the account may be properly watched. For a deferred sale the particulars and anticipated date of payment should be noted on the customer's account, or it may be preferable to hold over the invoice in a special file until the goods are delivered, using proper precautions to ensure prompt charging after delivery. When the revolving credit plan is used, the authorized credit limit should be noted at the top of the ledger sheet or file. For lay-a-way sales, the goods should be taken out of stock and earmarked, and adequate comments entered on the purchaser's account so that the transaction may be followed until completed. If recorded as a sale at the time the goods are set aside, they should not be recorded as a part of the store's inventory before delivery. It is conservative practice to adjust

OPERATING FORECAST FOR YEAR
UNDER DIFFERENT CREDIT POLICIES

	Present basis	With selected credit accounts	With liberal credit
Cash sales*	$ 95,000	$ 96,000	$ 97,000
Charge sales	5,000	8,000	11,000
Instalment sales	–	10,000	20,000
Carrying charges	–	1,500	3,000
Total income	$ 100,000	$ 115,500	$ 131,000
	40%	41%	42%
Margin (improved buying at larger volume)	$ 40,000	$ 46,740	$ 53,760
Current overhead	$ 30,000	$ 30,000	$ 30,000
Proprietor's salary	5,000	5,000	5,000
Added selling costs and advertising	–	2,000	4,300
Added clerical costs	–	700	1,400
Added bank interest	–	800	1,800
Bad debt losses	–	1,000	3,400
Total expenses	$ 35,000	$ 39,500	$ 45,900
Net profit	$ 5,000	$ 7,240	$ 7,860

* It was felt that cash sales would be slightly augmented by a campaign for credit accounts.

year end figures so that no profit will be taken on sales where delivery to the customer has not been effected.

Carrying charges made on delayed payment accounts need special attention in the case of those receivables outstanding at the date of any financial statement. The unearned portion must be calculated and the amount so entered that it will not be taken into the store's income for the period.

Controlling Credit

It is imperative to keep a strict control over the granting of credit, as a few sizeable bad debts could wipe out the profit of several months or more. An enterprise operating at a gross margin of 20% would have to obtain additional sales of $2,500 to offset the loss sustained by bad debts of $500, ignoring the additional overhead incurred. In a small establishment, only one or two persons should have the responsibility of authorizing credit on new accounts or extending the limit on old ones. The same parties should also watch continuously and closely the condition of all open accounts receivable and take any step necessary to enforce collection immediately when it becomes necessary. All sources of credit information available should be used, such as credit bureaus, banks, employers past and present, and the names of any other references supplied. A separate credit file should be kept for each customer.

The type of goods sold will affect the amount of credit which should be given. If the store sells consumers' goods, such as food or footwear, the credit limits would be smaller than if the merchandise were more lasting such as furniture or large appliances for the home, which items may be repossessed if sold under conditional sale contracts.

It is important that collection procedures should be instituted immediately an account becomes delinquent, and be followed up as soon as the next succeeding measures are indicated, as debts are more difficult to collect the longer they are outstanding. Generally speaking, the following steps should be taken on any account for consumers' goods:

1. Polite "past due" notice on the statement of account at the end of the first month of delinquency, or sooner under some circumstances.
2. Second more urgent "past due" notice at the end of 15 days.
3. Collection letter or series of collection letters at short intervals increasing in strength of demand.
4. Telephone call, or visit with customer if warranted, to see if there are special circumstances involved or if a frank discussion will achieve a satisfactory repayment plan.
5. Placement of the account in the hands of a lawyer, collection agency, or division court.

Of course each situation must be judged on its own merits, and delays permitted or measures taken which the management feels will be in the best interests of the business.

One of the most difficult problems is for the owner to estimate the degree of extension of credit which will produce the greatest net profit in the end result. The policy should be varied from time to time as economic and local conditions change. Some of the factors which should be considered may be seen in the following simplified example relating to a store selling bicycles, outboard motors, sports equipment and allied lines. Charge sales had been discouraged so that 95% of the total sales were for cash. It was decided to determine the most likely results if credit sales were extended on (a) a carefully selected or (b) a more liberal credit basis on sales in excess of $25. The foregoing exhibit shows the anticipated results in a condensed and simplified way. Such forecasts help a proprietor to decide the course of action he should follow.

Sales are not made directly by keeping records, but sales records are indispensable to an effective sales program. Similarly, control over the granting of credit and anticipated losses incurred through customers' bad debts are of equal importance in maintaining a close check on the operations of the business. Such records contribute effectively to the maintenance of good relations with customers and creditors, both of whom like to deal with an efficient concern that conducts its affairs in a businesslike way.

C. I. C. A. CONFERENCE 1958

Management Planning and Control

Long-Range Planning

J. A. DESROCHERS

Much has been written about planning, short or long-range, and more will be written as time goes on. Is this a new science on the threshold of the atomic age, is it an improvement of existing methods, or a combination of both?

Planning is not a new discovery. People have been making plans from time immemorial. Wars have been planned; peace is still being planned. Every day of our working life we plan for today, tomorrow, next year. We even plan for the day when we will no longer be at the helm of our business ship, or at the head of our family. Therefore, we must agree that short and long-range planning has been with us for a long time. However, it is really since the last war that forward planning has come into its own.

With notable exceptions, most companies in the past looked ahead one or two years only. Beyond that the future appeared so nebulous that the majority refused to cross the divide between the known and the unknown.

This viewpoint is rapidly changing and more and more companies are now engaged in long-range forecasting in order to determine their future course of action. We cannot ignore this fact and we must wake up to the realization that a new tool has been forged and is ours for the asking. Should we use it or be satisfied with pre-atomic weapons of business?

A Necessity or a Passing Fad?

Without a shadow of a doubt, we need a blueprint in order to conduct our respective businesses in the years ahead. Only those who plan their future will survive and grow. The others may drift along for a while carried by their own momentum, but inexorably they will decline and eventually disappear from the business scene.

In this atomic age, more than ever before, it will be the survival of the fittest. No business or profession, small or big, can afford to do without forward planning, whether it is called "charting the company's future", "planning ahead", "program for corporate growth" or "the long-term outlook". All major moves in the business world have been preplanned. Mergers, consolidations (including those in the accounting profession), acquisitions and diversification pro-

grams are the results of plans developed in the past, sometimes years ago. We cannot and should not remain static and hope that the good old days will come back. We either go forward or drop out of the race. The only way of our economic life is through long-range planning. This is a challenge to enlightened management.

Organization for Long-Range Planning

Long-range plans will be the end result of management's effort in setting up the team who will assist the chief executive in providing, assembling and interpreting the data required.

It is a job, not for top management alone, but also for divisional and departmental management. It has to be a team responsibility. As captain of the team, the chief executive will be the motivating influence over the group. He will spur them on, arouse or reawaken their enthusiasm; he will coordinate their work, but in the final analysis his colleagues will have to do the work.

Therefore, the first task is to bring together the topmost executives who are responsible for the staff or line functions. The chairman will define the problem at hand and explain the reasons why he feels that a long-range plan is essential for the company's future operations. He will point out that the atomic age economic revolution makes it imperative for the firm to shake off some or most of the time-honoured tenets of company policies, methods and procedures. He will tell them that imaginative thinking is needed in order to set realistic goals and map out a program of action to reach these goals. He will outline what is expected from each member of the group. He will not minimize the difficulties that they will have to surmount but will also try to show the benefits that will accrue once the plan is completed and in operation.

Basic Objectives

Before launching the project, the chairman will set, with the assistance of the team, the basic objectives or long-term goals. These may vary from company to company, but in essence will be somewhat along the following lines:

1. Volume of business desired 5 or 10 years hence.
2. Share of industry expected to reach.
3. Type of company organization required.
4. Expected profit and return on investment.
5. Capital required to do the job.

Division and Coordination of Work

The die is cast. The group is all geared up to plunge into the unknown, but it should do so in an orderly fashion, otherwise confusion and chaos will result.

The chairman or coordinator will distribute the tasks among the members of his team. A program of action will be mapped out for each function, outlining the job to be done,

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J. A. DESROCHERS, C.A. is president and general manager of Dow Brewery Limited, Montreal. He has previously been associated with Credit Canadien Inc., and Frontenac Breweries Limited, and has served his present firm in various senior capacities before his present appointment as president in 1957. He is a member of the Institute of Chartered Accountants of Quebec and a Fellow of the Quebec Branch of the Chartered Institute of Secretaries.

together with a deadline for its completion. The group should be reminded that although they are being asked to forecast the future, their estimates should be reasonable and not pure guesses or hunches. They will have to draw from experience and statistical information available in order to project their thinking into the future. They should not, however, rely entirely on historical results, but use the most modern methods of forecasting available, which are well known to analysts and forecasters.

Once under way, long-range planning must be followed up and properly coordinated. Periodical checks and reviews must be maintained and progress reports submitted in order that the deadline be met.

Step-by-Step Procedure

The appropriate time span for long-range planning should be 5 years. Less than that is short-range planning. As a start, a 5-year master plan should be developed, not only by years, but also by months. This will give 60 periods in which to match actual results with targets. Once enough experience has been acquired in working out the 5-year plan, the second 5-year span should be tackled, and so on. The principles involved will be the same.

Sales Forecasts

The sales volume and dollar objectives should be distributed by years, months, products, brands, packages (if any), markets, in order to arrive at a total dollar figure for each month.

In arriving at the volume of business and share of industry desired, a considerable amount of research and projection is required. "Weighted" factors have to be determined and evaluated on the basis of how heavily they influence the total market level. Some of these factors are personal disposable income, adult population shifts and adult per capita consumption.

A great number of statistical information sources have to be tapped, such as:

1. Publications of Dominion Bureau of Statistics.
2. Economic surveys.
3. Royal Commission Report on Canada's Economic Prospects.
4. Industry statistics (if available).
5. The company's own statistics.

We have to take into consideration growth potential of industry and company, population trends, rising standard of living, competitors' activities, selling prices over the next five years and manpower requirements.

Production Budgets

Once the detailed sales forecasts

Standing, left to right: **W. H. Flynn, chairman; M. S. Sutherland, member of C.I.C.A. Conference Committee.** *Seated, left to right:* **Roland Chagnon, Trevor Moore, J. A. Desrochers, R. D. Armstrong.**

are completed, production budgets must be developed accordingly:

1. Production facilities requirements for the 5-year span, type and location.
2. Manpower requirements.
3. Salaries, wage rates and fringe benefits.
4. Cost of materials, supplies and services.
5. Product planning.

MARKETING PLAN

A detailed marketing expense budget must be developed by the responsible executives. The budget should be designed to provide the maximum effort in order to market and sell the volume of goods which the company has set as its goal.

The budget, including selling expense, sales promotion, advertising, public relations and market research, will be broken down by years and by months.

Manpower requirements will be studied in the light of expected results.

A complete marketing plan will result from objective studies; it will blueprint the company's strategy for the 5 years to come. It will be in great detail, by years and by months. It will cover such items as advertising media, sales promotions, public relations activities and market research as well as sales operations.

CAPITAL REQUIREMENTS

Having determined that additional production facilities will be required over the next 5 years in order to satisfy the demands of the marketing people, a detailed master capital expenditure program must be developed.

This program will appraise existing facilities, their improvement and the construction or installation of new facilities. Cost estimates will be prepared setting out the total expenditures required over the period, by years and by months.

This program may be financed by two or more of the following sources:

1. Net earnings.
2. Depreciation provisions.
3. Investment portfolio.
4. Equity capital financing.
5. Short or long-term loans.

PRO FORMA PROFIT AND LOSS STATEMENTS AND BALANCE SHEETS

This is where the accounting profession really comes into its own. Sales people, production managers, marketing executives, staff experts, all have had a field day.

The financial executive now picks up all the loose ends and, under his expert guidance, shapes up the master plan. The following statements are submitted to the team:

1. Pro forma profit and loss statements, by years, and by months, by territories and by products.
2. Pro forma balance sheets for each of the 5 years.
3. Working capital comparisons by years.
4. Source and application of funds by years.
5. Return on capital invested by years.

The Master Plan

The job is nearly over, or is it? Are the projected profit and loss statement and balance sheet for the next 5 years the end result? No, they are only the beginning. We have the blueprint, but we still have to build according to the plan.

What constitutes the master plan? It is the total of all the individual plans and programs, prepared by the marketing director, production manager, staff specialists and treasurer.

The master plan is the way of life for the company from now on; master planning has given all the key executives an opportunity to make an appraisal of the firm's strengths and weaknesses. Special problems have been solved and policies established. Sales and profit potentials have been appraised and evaluated.

An audit of the company's resources, financial, physical and human, has resulted in plans designed to improve its position, facilities, methods and manpower reservoir. It has indicated the organizational changes required, the need for training and development programs, the need for better communications. Controls have been installed to give management better supervision over the various functions.

The company has now a plan ready for management action. It now possesses a corporate objective, policies and procedures. The days of management by "the seat of the pants" are over. Responsibilities are assigned as well as authorities commensurate with them.

The way is now clear to get the plan off the board.

Periodic Appraisal

Master planning is one thing; following up is another. All the weeks and months spent in analyzing, evaluating and forecasting would be wasted unless periodic reviews take place.

The plan will have to be revised, in the light of the experience gained in the first year. Patterns will establish themselves which will give management a better insight. Better ways will be found to do the job. New techniques will result from objective studies. An improved organization will be one of the many benefits accruing from the master plan. Guide ropes and yard-sticks will help the executives to do a better job of management.

It will be a never-ending job but one which will richly reward those who will have sweated "blood and tears" to make the plan workable and working.

This, however, will not come to pass unless the team watches its operations like a hawk, checking and double-checking, unless it reviews, appraises, evaluates, modifies, improves and constantly compares actual results in all spheres of corporate activity with the blueprint.

Only in this way will the plan work.

Money Management

TREVOR MOORE

Money has been referred to as the root of all evil. On the contrary, it is the root of all good, if you know what to do with it. Obviously, if money as such was done away with, evil would be committed for any substitute. There is nothing wrong with money, nothing wrong with profit provided it is used for further building or improving living standards, but it must be used.

One of the chief objectives of money management is for the business to manage its money in order that money not be allowed to manage the business. What this means, in effect, is that there is a normal or healthy financial pattern for every com-

pany. It will vary from the norm with the age of the company and with circumstances. If a business organization conforms to the pattern, it finds that it retains the respect of creditors and investors and does not find itself suddenly and unexpectedly pressed to find funds, the need for which it had not foreseen. The objective is not to keep out of debt but to keep out of the unexpected, unplanned-for borrowing which, if allowed to become chronic, can soon come to dominate a company's activities in all phases. On the other hand, too much ready cash for too long a period is not healthy either.

This means that whether they are launching a new company or operating an old one, the people managing money affairs must keep a constant eye on the capital structure. Assuming that the company's product and prices are acceptable and its employee and public relations are satisfactory, the capital structure is the measurement of financial health. Clearly, the most careful planning is required if capital structure is to retain its sound condition. Even more careful planning is needed if the capital structure is out of balance and must regain its health.

Cash Forecast

The chief instrument for gaining or retaining a healthy capital structure is the cash forecast. This is a deceptively brief name for a document which is really the outcome of a number of forecasts of prospective sales, operating and production levels. Chiefly from its operating departments, a company coordinates all the information and advice it can muster regarding estimates of sales, supply conditions, and the position of the company in relation to domestic, and perhaps world, markets. This is referred to as the operating program. It is compiled at least once each year and revised as many times as necessary. The estimates of departmental and corporate profits, capital expenditures, cash position, and so on are derived from it. Forecasts of production and sales take into account the probable effect of style changes and other factors which call for changing techniques of manufacture, possible expansion or contraction of the level of operations, possible new products and trends in operating costs.

From these forecasts can be determined not only the probable future course of operating receipts and expenditures, but the size and nature of the investments which will be required to maintain the company's position in the market or to improve its position or to diversify its operations and to improve the operating cost picture.

In other words, a properly drawn up cash forecast is sufficiently complete to permit one to project future earnings statements and balance sheets. From these it is possible to draw up future statements of the source and disposition of funds. The data from which the cash position is derived would naturally be broad enough to forecast the physical condition of the company, indicating its

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TREVOR MOORE is a director and vice-president of Imperial Oil Limited and, due to his background, is concerned largely with financial matters. He was formerly associated for 22 years with the investment firm of McLeod, Young, Weir & Co. Ltd. and became a vice-president and director of the company. He is a member of the Board of Trustees of the United Community Fund of Greater Toronto.

future capacity and the age of the varying producing units.

The cash forecast should be made or modified at least once a year and preferably oftener. It should carry several years ahead, 4 or 5 at least, with the knowledge that the farther ahead the forecast, the more likely it is to require substantial modifications as the period approaches. In some industries it is enough to forecast the cash position for a single date in the year. In the case of other businesses, and particularly in the earlier years of the forecast, it may prove desirable to plot the cash position on a month-to-month basis. For example, it might be necessary to show the monthly cash position for the first 2 years of a 5-year look ahead, changing to wider spacing for the subsequent years. This sort of consideration is particularly important for a highly seasonal industry in which all the outgo can sometimes be in the spring, all the income in the fall. In such industries, the year-end cash position might be extremely liquid, although by midsummer the cash shortage may be of nearly desperate proportions.

Financing for Flexibility

In the planning of a capital structure the yardstick is maximum flexibility, but this is naturally a yardstick which has to be used with discretion. The first essential is to get an *adequate* supply of capital at reasonable cost to the shareholder. The criterion of flexibility also has to be qualified with regard to the type of business undertaking. Some companies may have adequate flexibility even if the majority of their financing is by funded debt, such as utilities and pipe lines where income fluctuation is relatively small. Others should not indulge in mortgaging property under any circumstances.

But with these qualifications, flexibility provided through equity financing, either by new money or by means of plowed-in earnings, is frequently preferred by management and shareholder alike. That this is generally regarded as true can be deduced from the fact that from 1945 to 1954, undistributed profits and depreciation allowances financed 52% of the new investment in Canada. There have been instances in recent years of growth companies providing over 80% of their financing needs, and if the company or industry grows at a steady enough pace, it can adjust itself to providing virtually all its finances from internal sources.

Internal Financing

Internal financing, of course, should involve just as careful an appraisal of the company's position and needs as if the money were being sought outside. The investments to be made with plowed-in earnings or depreciation reserves should be carefully considered as to timing and type. The rate of return which is offered should be weighed. The period over which the capital will be tied up, i.e. the payback period, should be appraised. The net effect of each investment on the credit status of the company and on its cash inflow and outflow should be estimated. Internal financing should involve as careful an appraisal of the proposed investment as if one were borrowing the required funds from an institution.

Internal investment of funds also calls for careful policies to maximize the funds available. Working funds, receivables and inventories need to be kept in reasonable limits in order that

excess amounts of capital are not tied up in them. Assets not required in the business should be sold, and dividend policy must be framed on a long-term basis so that shareholders come to accept the plow-back principle, and at the same time enjoy a dividend rate maintained on a reasonably stable basis.

Shareholders normally approve of reinvesting earnings, since this form of financing does not involve the assumption of debt and leaves the company free to borrow externally in the event of emergency.

External Financing

By contrast, external financing can in some cases reduce a company's flexibility. The relationship ceases to be between shareholder and management but becomes one between borrower and lender and, unless due care is maintained, the lender's terms can restrict the freedom of action of the business. The raising of external money may be subject to qualifications contained in the company's charter as to changes in capital structure. Left for negotiation are the amount which can be raised and the nature of the securities to be issued in order that the cost to the shareholder should be low and the least impairment of future flexibility experienced. The achievement of these goals depends largely on the ability of management to navigate under prevailing money market conditions.

One form of external financing is the "sale and leaseback". This is a procedure under which a company may sell an office building to an outside agent and then arrange a long-term lease on it. Obviously the company's credit is involved in the lease which makes it attractive for the agent to retain or sell the investment. In many cases this type of financing has reached the point where the amount of annual lease rental needs to be shown as a footnote to the corporate balance sheet. Indeed, in the financing this year by the Texas Corporation in the U.S. of an issue of $150 million debentures, one of the trust deed provisions is to the effect that the fair value of all restricted property leased under sale-leaseback cannot exceed 5% of shareholders' investment unless an equivalent amount of debentures is retired.

With regard to financing by the issuance of first mortgage or unsecured debentures, the chief criteria are to keep volume of debt and interest charges within reason and to ensure that the debentures are sufficiently attractive in price and coupon to sell readily and stay "placed" with satisfied purchasers.

But the borrower also needs to remember the proven dangers of borrowing too much and being weighed down with interest charges in lean years, or of borrowing too little and having to make too frequent trips to the money market. These possibilities can sometimes be avoided by a short-term loan from the bank or the issuance and sale of a short-term note.

An Illustration

My own company (Imperial Oil Limited) issued common stock, $80 million in 1951 and $66 million in 1956. It has incurred debts of $50 million in 1949 and $50 million in 1955, sold assets (its investments in International Petroleum, Royalite Oil and other companies) and retained about 50% of its earnings in recent years for expansion. In the process it has kept the ratio of debt to equity below 25% (now below 15%) which it

feels to be a reasonable ratio, enabling it to get favourable borrowing terms as the occasion may arise. The ratio most certainly allows for flexibility.

The fact that it has been able to maintain satisfactory ratios on its balance sheet and a good measure of flexibility is largely attributable to the effective use of the cash forecast. The same forecast is also of vital importance in reviewing the need for investment in working funds, including inventories.

In recent years there has been so much emphasis on expansion of fixed plant that some have not recognized the need for more working funds to enable the new plants to be productive. The changing trend of business practices has called for wider use of credit cards, time purchase plans and other forms of credit. The rise of living standards has brought greater variety and the need to carry bigger inventories. These are real and important factors in the changing scene.

The very size of the working funds required for modern business points to the danger of either getting too little or too much tied up in them. Good money management insists on the adequate screening of investments, including extensions to working funds. A company must insist on control of credit and credit policies, and must maintain a vigilant control of inventories.

All this has brought the old-fashioned accountant and bookkeeper off his high stool, as it were, and down to the level of operating management. In an operating company the money manager must understand the language and need of the works manager. He must know enough about operating procedures to be able to pinpoint those areas where periodic routine analysis will quickly show what action should be taken, what dangerous "bulges" in the cash circuit are threatening.

If we can assume that through the agency of the cash forecast we have planned a capital structure so that it will provide the required funds, yet preserve the company's financial flexibility and stability and can also assume that the same cash forecast has helped to achieve control of working funds, inventories and credit, then the remaining job for money management is to provide for the profitable utilization of *spare* cash.

Management of the Cash Flow

The management of money involves both the planning and control of a corporation's cash flow. On a long-term basis, it ensures that there will be adequate funds available to meet the projected needs of the company in the foreseeable future. On a short-term basis it ensures that all funds are fully employed.

Cash control, as distinct from cash planning, is a question of organizing the cash flow so as to ensure that surplus funds are not locked away and that those spots in the cash cycle which absorb cash are under continuous surveillance. With regard to short-term planning, that is, for periods of 12 to 24 months, the first step in a company with widespread operations is to find out the maximum cash balance which operating units in the field should maintain to meet their ordinary day-to-day needs. If the operating unit is one which produces cash, this will mean that it will transfer into a central account any balance over and above the maximum required for its own operations.

Departments which do not produce cash must be maintained at the cash balance required to meet their everyday expenses.

Our company's rule in such cases is to have transfers made each day by wire to and from the central account. This, of course, is the routine procedure covering only ordinary movements. To carry it on successfully, centralization of cash control means that those managing the cash flow must be aware of large recurring and non-recurring cash requirements that lie ahead. To do this, we rely on a short-term cash forecast which is submitted every month by each of the operating divisions. This report covers the succeeding 3 months and shows what each department will remit to and receive from the central cash account.

These short-term forecasts indicate the approximate date and amount of any large cash need or overage that will occur during the 3 months. In a consolidated form, the report therefore provides an estimate of the cash position 3 months ahead.

These steps reduce the problem of cash management on a short-term basis. Operating departments maintain only the maximum balance decided upon and they transfer surplus funds to the central account. The minimum balance required in the central account can then be calculated from a study of the day-to-day requirements in the field. Finally, the pinpointing of the larger requirements ahead allows the cash to be accumulated and invested until the time when it is needed in the business.

Surplus Cash

The inference here is that if the projected capital expenditure is an appropriate length of time away, the money to meet it can be invested in a suitable short-term security. Capital is a costly commodity, and gains from investing help to offset the cost.

The investment of surplus cash depends entirely upon the estimate of the date in the future when the cash is needed in the business, that is, for how long the cash is going to be surplus. If the company is building cash and will do so as far as can be determined for a reasonable time in the future, investments may be of a long-term nature, say 2 years. If the organization is going through a period of cash drain, however, investments must be of a short-term duration. Obviously all such investments are picked for maximum security and liquidity. Suitable investments for this purpose take the form of treasury bills, which are short notes issued by the government once a week at a discount and having a 90-day maturity, also call loans to investment dealers, 30-day fixed or 24-hour call. Even more attractive to many are government interest-bearing bonds of short maturity and low coupon.

Another useful medium is that of short, secured or unsecured notes issued by finance companies and other large organizations. The rates on these are usually higher than those on treasury bills or short-term government bonds. In practice, a large corporation will have in its portfolio all of these investments maturing over a period of days or months.

The earnings on the idle funds of industry, even though the funds may only be invested for a short term, can become a significant addition to corporate profits. But while they themselves bring in a direct return, the indirect profits of money management

are probably substantially greater. For it is only by fulfilling the first two objectives of money management, the planned capital structure and the control of working funds that surplus funds become coralled for investment.

The investment of temporarily surplus funds is, therefore, the icing. The cake is good money management and the maintenance of flexibility, which means the maintenance of a company's ability to cope with financial emergencies.

Good money management is an essential and perhaps the most essential single element of good corporate management. Its influence is reflected in healthy balance sheets, healthy plants and premises and, above all, if practised widely enough, in a healthy national economy.

Control and the Long-term Plan

R. D. ARMSTRONG

The planning activities of a company fall into three main categories:

1. Grand Strategy
2. Strategy
3. Tactics.

Grand Strategy

The planning activity entails very long-term considerations of perhaps 25 years or more. It involves vital policy decisions on highly complex and interrelated economic, philosophical, political, organizational, financial and personnel considerations. It can only be expressed in financial terms in a most general way.

Strategy

Strategy is the first phase of the company's grand strategy and it deals with a much shorter period, probably not more than 10 years. The complexities involved in grand strategy are present here, but because the period is shorter and more closely related to current conditions it is possible to express the plan in measurable specifics and to devise and operate controls to measure accomplishments against objectives. Of equal importance is the provision of a basis for the regular re-examination of the validity of the plan itself.

Tactics

Tactics are the short-term, day-to-day manoeuvres, conducted within the framework of the long-term plan. The company's tactical intentions are usually reflected in monthly, quarterly and annual operating budgets and in annual physical capital and financial capital budgets. Expression of the tactical plans is invariably in specific financial terms. These represent specific actions which operating management is authorized to pursue. The control and assessment of competence of performance is exercised by statistical and accounting methods.

Inter-Relationship of Planning Activities

It is evident that there must be a strong interrelation between grand strategy, strategy and tactics, and therefore it is not feasible to divorce fully the control systems that apply to each. However, the importance of the various elements is so different as between the long-term or strategic plans and the annual operating budgets of the short-term or tactical plans that the control systems are in fact very different.

For example, an effective organizational format is a prerequisite to a

company's success. While in any one year there may be numerous staff changes in addition to revisions of responsibility and authority, no major organizational change can be implemented and made effective within one year. To cite another example concerning capital expenditures, the time required to plan, construct and place in operation major new physical facilities is such that probably only the expenditure phase can be controlled effectively through an annual budget.

Elements of the Long-Term Plan

It is difficult to be specific in discussing the essential elements of control of the long-term plan because the relative importance of the various elements vary so widely between industries and between companies in the same industry. Within an industry the control problems of each company are unique. This is due not only to geographical considerations and the state of maturity that has been attained, but also because basic organizational formats differ widely between companies. The companies themselves are undergoing constant change. It is more suitable, then, to discuss the problem in terms of elements and principles rather than methods.

Rate of Return

The rate of return on invested capital must be the ultimate expression of all long-term plans and the focal point of all effective control systems. This may appear to be an over-simplification but is really a recognition of basic realities for a number of reasons. First, a long-term plan invariably entails major capital investment. Secondly, in most cases capital expansion cannot be undertaken on a gradual basis; it is almost always prudent to build substantial excess capacity into a new facility. The cost of this temporarily non-productive capital will impinge on the short-term rate of return and will accentuate the normal fluctuations consequential to changing business conditions. Thirdly, the use of funds for capital purposes presupposes the assignment of priorities to projects, the withholding of cash that could otherwise be distributed to shareholders, and the development of a comprehensive financing plan that will be equitable and beneficial to the owners of both borrowed and equity capital. Lastly, it is extremely difficult to bring about sensible short-term changes in invested fixed capital.

Elements of the Rate of Return

The rate of return is the product of a number of interrelated factors: gross sales, advertising, sales and administrative expenses, cost of carrying inventories, materials, labour and other operating expenses, depreciation and income and other taxes. It is possible to devise a considered "mix" of these factors which will optimize the rate of return. Although these factors are always present, they are far from static. Each is the product of a variety

R. D. ARMSTRONG, F.C.A. is vice-president, accounting and finance, Canadian National Railways. Prior to joining the company in 1953, he was director of finance and administration for A. V. Roe (Canada) Limited. In his present position he has been responsible for an intensive mechanization program which has seen electronic data processing machines put to use for processing Canada's largest and most complex industrial payroll. He is a member of the Institute of Chartered Accountants of Ontario and was elected a Fellow of the Institute in 1956.

of potent and ever-changing forces. Identifying and coping with these forces is essentially a problem of short-term planning and control. It is a series of tactical manoeuvres conducted within the grand strategy of the long-term plan.

The rate of return itself has a number of variants and modifications. One variant that is particularly useful in considering the relative attractiveness of major capital expenditures is the discounted cash flow or time-adjusted return technique. This involves the calculation of the annual cash flow with respect to a project and the discounting of each year's cash product to present value. While this is a form of average rate of return, it has the added advantage of attaching a higher value to returns predicated for the earlier years. While an early high rate of return is not necessarily conclusive, it is a factor that should be considered within the context of the company's whole program.

Controlling the Long-Term Plan

Most long-term plans can be expressed in summary form as a combined operating, physical capital and financial capital forecast. This forecast should be on a monthly or quarterly basis for the current year (it is in fact the budget for the year) and on an annual basis for at least the 9 succeeding years. Some major companies extend these forecasts from 10 years to a 20 to 25-year projection.

The budget portion of the forecast is usually the only phase where specific authorizations exist. These apply to departmental operating expenditures required to support the sales forecast, the physical capital budget and the financial capital budget. The physical capital and the financial capital budgets have both short-term and long-term connotations.

The annual operating budget is basically an aggregation of revenue and expense performance objectives assembled on a departmental basis or on some other basis as may be appropriate in associating income and expense with responsibility, authority and accomplishment. Although it represents a specific plan compatible with the company's general long-term strategy it is essentially a tactical program. It is flexible and subject to frequent revision and close-up specific control.

Long-Term Forecast

The forecast covers at least the 9 succeeding years and is a projection in financial terms of the company's strategic plans. It is an expression of objectives and expectations but it seldom if ever authorizes action. The long-term forecast is composed of three main facets:

1. Operating results, which comprise projected volumes, revenues and expenses by products and/or divisions.
2. Physical capital requirements, which represent the amount of cash to be expended on new property, plant and equipment.
3. Financial capital forecast, which sets out the source and disposition of funds year by year and which projects dividend policy, refunding and new financing.

Most elements of an annual operating budget can be prepared by the projection of a sales forecast and be controlled and/or revised monthly on the basis of actual accounting results, operating statistics and short-term forecasts. However, the considerations surrounding the long-term plan

are very different. Because the forecast can include major physical capital and financial capital variables to an extent not feasible in the annual budget, the interrelationship between the operating, physical and financial facets is much stronger and very much more complex. Also, the annual operating budget is in large measure the projection of the immediate past into the immediate future. This means that its administration is in large measure effected through the assembly and analysis of current accounting and statistical data. This type of specific material is of little use, however, in assessing the complex economic, philosophical, political, organizational, financial and personnel considerations entailed in a long-term plan, even though the forecast of the results of the plan is finally summarized in accounting terms.

Summary and Conclusions

A long-term plan is essentially a product of objectives and of the strategy by which those objectives are to be attained. Although it represents the best current opinion as to what the future holds and the most effective strategy the company can adopt to develop its potential, it is necessarily the product of so many complex and interrelated tangible and intangible factors that it is merely a guide and not a rule.

Although such a plan is usually expressed in financial terms, the assembly of current statistical, accounting and financial information fundamental to effective use of the short-term tactical control instrument, i.e. the budget, is just one of many factors which must be kept under constant professional surveillance in controlling the long-term plan.

The organizing and administering of effective controls over the long-term plan, the assessment of the changing views of the future as expressed by experts in economics, finance, market research, product development and industrial engineering (among others), and the consequent periodic modification of the long-term plan is one of the prime functions of senior management and the board of directors of the company.

The organizing and administering of the long-term plan is a challenging function. The professional accountant can make a most effective contribution, particularly if he will assess the similarities and differences between the problems of controlling short-term and long-term plans and if, in the case of the long-term plan, he will broaden his perspective and modify his penchant for exactitude and precision.

Essential Elements of Control

ROLAND CHAGNON

The responsibility of management is to show the highest possible return on an investment. To do so, it must utilize to the highest degree all the intellectual abilities of the men it employs, and make the most efficient use of all the plant, equipment and capital it controls.

As a result of the combination of all these efforts, there should be a profit which, in our economic system, is the only yardstick to measure management.

Cost and Expense Control

Lower production costs, lower selling and administration expenses point

up the difference between an efficient and a less efficient management. As a matter of fact, in many operations, it is the only difference. It is therefore quite evident that the controls of these factors are most important.

To exercise a minimum control on production, cost and expenses, management must be at least supplied with statements of cost and expenses which give all pertinent information to permit easy study of the situation, and quick corrective actions.

To be of value, these statements must be:

(a) *frequent* – at least once a month;
(b) *up-to-date* – i.e. produced within a short time after the period covered;
(c) *exact* – should not include any estimation;
(d) *detailed* – give all the factors needed for good management;
(e) *comparative* – to corresponding period last year and up-to-date this year and last year;
(f) *dynamic* – analyzing each operation and indicating tendencies, giving all pertinent information which management requires to take effective action.

Static statements should definitely be abandoned as useless; only dynamic and lively statements are valuable.

As an example, if the operating statement of a truck shows that the truck has an operating cost of 0.14 a mile, it is incomplete and static. In fact, the cost of 0.14 a mile is exact only if the car has travelled a definite number of miles, say 10,000 miles. The cost of 0.14 will increase if the car runs less than 10,000 miles and will decrease if it runs more.

To be more accurate and dynamic, the statement would give a better picture and allow comparison if it showed that the truck costs a minimum of $700 per annum to cover fixed expenses such as depreciation, licence, insurance, interest, garage, and 0.07 a mile to cover variable expenses such as gas, repairs and tires.

A dynamic statement of expenses should, for instance, be prepared to allow quick detection of the reasons for increases, whether they result from an increase in the number of services purchased or higher unit cost. For example, does the telephone bill increase result from the use of a larger number of sets, more expensive sets or an increase in rates? Do higher labour costs result from more employees or higher hourly rates or increased work hours?

There is no fixed formula to produce a dynamic statement. Each case must be studied according to its merits, the requirements of management and the kind of business. All statements should be prepared to measure exactly the performance of the different key employees and make them aware of their responsibility.

The distribution or prorating of certain expenses by percentage or any other method over a number of divisions or departments should be seriously frowned upon. It only means frustration for the operator who

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ROLAND CHAGNON, C.A. is president and managing director of Fred A. Lallemand & Co. Ltd., Montreal and holds a directorship in several other Quebec companies. He was formerly associated with Dupuis Frères Ltée, Montreal, where he served in several financial and administrative positions. He is a member of the Institute of Chartered Accountants of Quebec and a past president of the Montreal Chamber of Commerce.

is charged an amount of an unknown composition, coming from nowhere and over which he has no control. The splitting of expenses in small amounts to be distributed over a number of accounts may even mean that the unwarranted expenses of certain departments or divisions are effectively removed from the control of management.

All these apportionments, being more or less arbitrary, may sometimes be absolutely unfair to the department head. For instance, an administration charge of 3% of sales made to branches of a firm does not seem exaggerated; it even looks quite fair. It is, however, quite evident that if this charge is real when there are 100 branches, it is not so when there are 150 branches. One can see that the additional revenue produced by the 50 new branches could easily cover additional unwarranted expenses incurred by an administration that has become inefficient.

Furthermore the 3% charge on sales does not permit true and real comparisons between branches. The branches with higher volumes are probably absorbing too large a share of administration while smaller volume and more difficult branches are not carrying their full load.

The total contribution by each branch to total administration cost would probably show a clearer picture.

The classification of expenses as variable, semi-variable and fixed leads to the presentation of more informative and dynamic statements. The attention of management and key employees is drawn directly to the variable and semi-variable expenses which will logically be more closely scrutinized and therefore better controlled.

Furthermore, if these statements are prepared in such a manner that copies can be made available to every key employee concerned, for his examination and analysis, it will be easier to hold the interest of these employees and obtain their full cooperation to keep expenses at a low level.

For better and finer controls, additional statements of expenses could be prepared in which all expenses appearing in the different statements published would be incorporated but regrouped differently under a natural classification which is very simple but quite revealing. Here is a suggested classification for such a statement that can really be useful in controlling expenses, by giving a quick overall view:

Wages
Salaries
Supplies — Heating,
    Gas, oil,
    Stationery, office
General repairs
Cartage
Travelling
Advertising
Sundry Expenses
Purchase Services (water, electricity)
Rents,
Taxes, licences
Insurances — Automobiles — building — equipment
Depreciation

Budget

The production of frequent, up-to-date, detailed and dynamic statements fitted to the need of each business is a minimum requirement of control. However, this control will really be efficient only if the results are compared to predetermined plans, if the statements show comparison not only

with last year's figures but especially with a planned figure of efficiency giving full effect to all improvements made in the operations or to be made according to decisions of management.

To manage effectively is to forecast, formulate plans, analyze results, compare plans and take action. Effective short-term control therefore means planning, setting objectives, determining means to achieve these objectives which, when translated in figures, become a budget. To have any value, a budget must be well prepared, detailed, dynamic and easily understood.

Budget Preparation

We must insist that a budget is not a mere estimate, a tentative projection or an ordinary provision. It is not a guess but the result of hard work and thinking. It represents the cooperative effort of all levels of an organization to set goals to be attained, and translate, into figures and statements, the results projected at different levels of operations.

As expenses are really made by the key employee at the lowest level, superintendent or foreman, who controls the employees who use machinery, tools and raw materials, it is therefore absolutely essential that, to be well prepared, a budget should result from the effective cooperation of all employees. It will also help to have them understand that the budget is a guide or plan of their work to help them do a better job and should never be considered as a control over their work.

To benefit fully from the key employees' knowledge and help, in the preparation of the budget, it is necessary that they be supplied with all possible information such as detailed statements of operations for their division or department, showing evidently only variable and semi-variable expenses with full comments, and explanation as to variations.

It need not be emphasized that the budget cannot be a mere listing of previous years' figures without further ado. It must be thoroughly studied to take into account new developments introduced during the year as well as all planned and foreseeable changes for the coming year.

The budget at each level must represent only planned statements and figures that can effectively be met by a keen management.

Details of Budget

To control fully, the budget should be broken down to cover the smallest units, the finest operations. Each cost should be analyzed and, relying on past experience, a normal estimated cost set for each operation which becomes the goal to reach. Every single phase of administration, selling and production costs must be covered before determining the overall budget.

The detailed budget will obviously be presented in the same form as operating statements, using the same terms and classification for eventual easy comparison.

Dynamism in Budgeting

The budget should provide all the information needed to allow quick and intelligent corrections in face of new problems. As an illustration, it is easy to see how dangerous it would be for a foreman to omit making certain repairs to his machinery in order to keep within his budget. He would certainly not fully understand his responsibility, and his lack of action might prove very costly in the future.

These corrections to the budget are of course exceptional but must be accepted at all levels as a possibility. Every one should know where his authority lies and not be afraid to use it. No budget can or should replace the human judgment that it is supposed to help.

UNDERSTANDABLE TERMS

The budget should be prepared in terms or in units recognized and accepted at the level where it is to apply.

The periodic statements prepared to compare with budget figures should of course be in the same terms and units but fully integrated with the general accounting.

EXPENSE CONTROLLER

Yearly and monthly budgets and periodic statements are important elements of control, but they will rapidly become meaningless if the daily operations that are reflected in them are not regularly checked, which points to the importance of an expense budget controller.

In small or medium-sized firms, this function is held by the treasurer or accountant. In larger organizations, this employee should be independent reporting directly to the general manager.

His responsibility is to examine all expenses as commitments are made, pointing out doubtful items to the foreman or superintendent concerned. If no agreement can be reached and the expense scrutinized is important, attention of management at the higher echelons should be drawn.

The controller should not take any active part in decisions but act as a counsellor. He should be accepted by every one as a friend who wants to be of help in a difficult situation rather than as a watch dog.

Control of Profits

Profit is the result obtained from all the operations of an enterprise during a definite period. It indicates the returns on invested capital and serves as a measure of good management.

Many important factors affecting profits are not entirely controllable by management. Examples are *sales volume,* which is influenced by the general economy of the country or the region, and sometimes by the weather; *labour costs,* which depend to a large extent on labour contracts and might increase costs without an equivalent increase in selling price; *selling price,* which is fixed by demand and competition.

It is obvious, in view of the complexity and number of factors leading to a profit, that it is impossible to forecast or budget an exact profit, but the very existence of such difficulties and complexities makes it mandatory that management take all the necessary precautions to obtain the best results. It should control all the factors it can directly influence and be on the alert to meet all new and abnormal situations as they arise.

STATEMENTS OF PROFIT AND LOSS

The very first elements of control are again to be found in the production of complete statements periodically and frequently produced which will give the exact results for each period and up-to-date and compared with the previous year. These operating statements should be, like the expense statements, dynamic and exact, set up to serve the real need of the business and not exclusively the re-

quirements of the banker or for the annual report to shareholders.

An operating statement should be produced for each division or subdivision and for each product. To do so, it might be necessary to establish a selling price at which goods would be transferred from one department to another. An operating supervisor who is supplied with this kind of information finds much more interest in his work and will undoubtedly try to increase his efficiency. He will have become an interested partner and it should reflect in his attitude.

The same treatment could be given to the sales department which could be charged with the goods at a fixed price and where it would have to show a profit after its selling costs.

Statements of profits for each product should also be prepared not only to determine their importance in the overall picture, but also to be able to gauge the influence on profits in the change in the cost or selling price of any product. These statements are to be distinguished from standard cost, for they give exact profits realized after taking into consideration all sundry factors that have changed the standard cost.

When talking of profit per division or product, one should always refer to direct profit, that is sales less direct variable and semi-variable production and sales expenses, in other words, the profit realized on sales less all expenses that could be eliminated if this product were not made. Indirect and fixed expenses must be met, but they are not directly connected with production or sales or influenced by them and especially cannot be controlled by any lower-level key employee.

Profit Budget

As stated previously, budgeting is really the only effective way to control, and this applies also to profits which can be budgeted by using projected sales, expenses and cost figures already discussed.

The budgets should follow the line of the operating statements and be set up for each division and subdivision as well as for each product.

Comparison of actual results with the budget will point to differences, and after their analysis it will be possible to determine:

(a) Corrections to operations which must be made to arrive at projected profits;

(b) Corrections to budgeted profits due to new and uncontrollable factors.

A good profit budget should be broken down by department and division, and every key employee should have to take part in its preparation and be responsible for its fulfilment. For this purpose he should be furnished with periodic statements.

Break-Even Point

It is very important that management be fully informed at what sales figures the operation of the company passes from profit to loss, that is, what is the break-even point.

After the rather prosperous economic conditions enjoyed, such a problem has most likely been forgotten. A more hesitant economy has just reminded us that it might be sensible to think of it.

Whatever are the conditions, such a break-even point should be established for each enterprise, for each division and for each product. It should be kept up to date by giving

effect to all new factors as they develop.

Cash Control

Effective cash controls mean budgeting. It has rightly been said that one of the first rules of business is that the payroll must be met on Friday night, otherwise the plant might just as well remain closed on the following Monday. It would be of no help to tell the workers that the production has been sold on credit, at a very good profit, for future delivery. They need the cash and want it on pay day.

The cash situation, although closely related to the other activities of the business, should nevertheless be considered by itself. Sales on account may be highly profitable but they do not mean immediate cash. Even made at a loss, cash sales may sometimes be preferable.

A cash budget is therefore very important. If the working capital is very small and not much more than needed, then a good planning is required to eliminate cash shortages that are bound to happen and which could be dangerous.

If, on the contrary, there is plenty of working capital, good management would require that a detailed cash budget be made to establish when the surplus cash will be available for other remunerative purposes or to make short-term investments.

As its name implies, cash budgeting means the forecasting of the receipts by period and the disbursements for the same period which, added or subtracted from the cash at the beginning of the period, will show the cash on hand or lack of cash at the end of the period.

Cash budgeting is rather complex as it is affected by all the other budgets already prepared such as sales, expenses, profit and capital. It is difficult, although quite possible, to imagine a reliable cash budget without the benefit of complete budgetary controls for all the other activities of the business.

The cash budget should be prepared for the whole year and broken down to the monthly and other time periods chosen for the expense and profit budgets. Like all other budgets, but to a larger degree, it has to be flexible, for it is made from the forecast of others. Its preparation is the responsibility of the treasurer, but he needs the active cooperation of the sales and production managers to fully interpret their own budget, make them aware of the cash problems of the business and enlist their help to meet the difficult periods.

There is a general practice of budgeting cash by a break-down of all the items of receipts and disbursements such as:

Receipts:

- Accounts receivable
- Notes receivable
- Cash sales
- Rentals
- Sundries

TOTAL —

Disbursements:

- Payroll
- Notes payable
- Material purchase
- Factory expenses
- Selling expenses
- Administrative expenses
- Licences
- Fees
- Taxes
- Interests
- Long-term borrowing, i.e. payments
- Capital expenses payments

TOTAL —

Increase or decrease in cash

Plus or minus: Short-term borrowings or payments
TOTAL –
Cash on hand beginning period
Cash on hand ended period.

This method is difficult to balance and tie into the results of the other budgets.

Another method used, which some find preferable, is the budgeting of cash through the use of pro forma periodic balance sheets giving effect to the monthly results budgeted for sales, manufacturing cost, expenses, profit and capital expenditure.

Cash can be considered as the clearing account or medium of settlement of all other transactions. Each transaction started, whatever its nature, will terminate with a cash transaction. Therefore by forecasting the detailed items of pro forma balance sheet, the end result will show the effect on the cash account.

In a pro forma budgeted balance sheet, the accounts that are the most affected and most complicated to forecast are accounts receivable, inventories, accounts payable and surplus.

It seems superfluous to explain how with the aid of the sales budget, past collection pattern and experience, it is possible to determine the accounts receivable forecasted for the end of every month of the year.

The same applies to inventories determined with the use of budgeted purchase figures and cost of sales of the profit budget.

Accounts payable will have to be divided at least into four groups to make the forecasting easier:

1. *Accounts payable operating*, which would take into account:
   (a) purchases and normal expenses appearing in the cost of goods budgets and expense budgets;
   (b) the terms of payment and the normal payment pattern of the above.
2. *Accounts payable capital* expenditures, for the periods outlined in capital expense budget.
3. *Accounts payable payroll*, which varies according to forecasted activity.

4. *Accounts payable sundries*, for taxes, licences, insurance, dividends, etc. Once these principal items are determined and forecasted it is quite simple to complete the pro forma balance sheets.

On the asset side, prepaid expenses account will increase as payments on such items become due and show diminishing figures as they are charged to operations.

Capital account will increase as set out in the capital expenditure program.

On the liability side, long-term borrowings will be decreased during the months when it is known payments become due. Surplus account will reflect the profit or loss budget and dividend payments.

Accruals of non-cash reserves will be made monthly according to predetermined rate. The balancing figure of this pro forma balance sheet will be cash, the clearing account previously explained, and it will show either a debit or credit position.

If it is a credit position, immediate action should be taken to be prepared for that particular period, the solution being short-term borrowings, pressure for prompter collections or arrangements with creditors for temporary longer terms.

This becomes the treasurer's and management's lot, but what is to happen in the near future is clearly laid down. Plans can be drafted to meet the situation, thanks to the existence of a good short-term cash control.

Conclusion

Control is always needed and should never be relaxed. However, in prosperous years when profits are plentiful, control formulas may have been forgotten. In a less buoyant economy, it becomes quite urgent to make use of all the control elements to be able to show a reasonable return on investment, the yardstick of good management. It is the responsibility of accountants to gather the necessary data and furnish the information needed, to set up the controls required by management so that it will succeed in its task.

Signs of Vitality

I think that the degree of vitality in an administration is best judged by the manner and speed with which it responds to the challenge of the changing situations that confront it. The reflex action in the human body provides a parallel illustration of what I have in mind. When a human being finds himself in any particular situation, the circumstances of that situation are rapidly transmitted to the brain by the objective senses. The relevant portion of the brain instantly decides what action should be taken and the decisions of the brain are carried out by the legs, arms or other appropriate part of the body. This three-part process must be reproduced in any administration which is to carry out its functions properly. First, it must have sensitivity of perception in order to become quickly aware of the existence and nature of a situation calling for action. Secondly, it must have the ability to decide swiftly what precise action needs to be taken in response to that situation. And thirdly, there must be prompt, energetic and efficient execution of the decisions reached.

—Basil Smallpiece in "Vitality in Administration".

Edited by W. BARRY COUTTS, C.A.

Accounting Research

Discount or Premium and Expense on Long-term Debt

The second edition of "Financial Reporting in Canada" shows that approximately 50% of the companies surveyed for 1956 depended to some extent on long-term debt for part of their capital requirements. Even if the proportion of the companies not included in this survey is somewhat less than that percentage, the proportion of all Canadian publicly financed companies making use of debt financing is probably still quite substantial.

Presumably, because of the tax benefit which Canadian income tax law confers upon the purchaser of debt securities at a discount and also because the purchase of anything at less than face value appears to many people to be an almost irresistible bargain, most issues of funded debt in Canada are offered to the public at a price below par. The accounting problems relating to the treatment of discount and issue expenses are, therefore, of quite wide application and interest. Under current Canadian conditions premiums are rarely encountered on the issue of debt securities. For this reason and since the problems relating to such premiums are essentially the same as those relating to discount, this discussion will be restricted to a consideration of the problems concerning discount.

There are actually three accounting problems which arise in connection with the treatment of bond discount and expense in the accounts of the issuing company. These are: the timing of the transfer of these items to income account or surplus, the balance sheet treatment of any amounts not immediately written off, and the disposition of any unamortized balance when the related debt is redeemed, refunded or converted prior to maturity.

Amortization of Bond Discount and Expense

On this continent, it is generally recognized by accounting theorists that debt discount and expense represent adjustments of the effective interest rate and costs of financing and must, therefore, be spread on some rational basis over the term of the debt. The preference for orderly amortization expressed by writers on the subject in the United States receives definite reinforcement from the American Institute of Certified Public Accountants. Its Committee on Accounting Research stated in Chapter 15 of Accounting Research Bulletin No. 43: "In the committee's opinion it is a sound accounting procedure to treat such discount as a part of the cost of borrowed money to be distributed systematically over the term of the issue and charged in successive annual income accounts of the company. The anticipation of this income charge by a debit to income of a previous year or to surplus has in principle no more justification than would a corresponding treatment of coupons due in future years."

It is further pointed out, in this bulletin, that the alleged advantage of conservatism attributed to immediate write-offs is ". . . of dubious value if attained at the expense of a lack of conservatism in the income account, which is far more significant." The American Accounting Association expresses similar views.

As is the case with all opinions expressed in accounting research bulletins, the Securities and Exchange Commission regards these recommendations as an indication of the "generally accepted principle of accounting" appropriate in the circumstances. It insists on the periodic amortization of the discount or premium and expense on long-term debt except when the amounts involved are clearly not material.

Opinion in the United Kingdom would appear to be less definite than in the United States. Accountants there seem to be more influenced by the legal view which regards discount and premium as capital items not affecting income. They may also be influenced by the taxation laws which regard the interest on funded debt itself as a distribution of profit rather than a deduction to be made in arriving at profit. Periodic amortization of discount is apparently, as a result, relatively uncommon although it appears to be regarded as an acceptable practice.

As perhaps might be expected when accountants in the two countries to which Canadians usually look for guidance hold conflicting views, practice in this country is far from uniform. There have been no specific pronouncements on the subject by the C.I.C.A. except indirectly in dealing with disclosure in Bulletin No. 14. Similarly, none of the Companies Acts does more than require disclosure of the amount written off in the year and the amount remaining at the end of the year.

"Financial Reporting in Canada" does not refer specifically to the amortization of bond discount and expense in its surveys either of balance sheets or of income statements. It is impossible, therefore, to determine exactly what proportion show debt discount and expense in the balance sheet, or reflect the amortization of such items in their income statements. However, a separate sampling of published financial statements of Canadian public companies indicates that nearly half of the companies with funded debt show neither a charge for amortization in the income statement nor an unamortized balance on the balance sheet. It is possible, of course, that in some of these cases the amounts involved may be present though not specifically referred to. In other cases, the amounts may not have been considered to be material under the circumstances. It does seem, nevertheless, that there must be a substantial minority of Canadian security issuers who believe that the deferment of discount and issue expense on debt securities and the regular amortization of these items over the term of the debt is either inappropriate or unnecessary.

It is, of course, impossible to determine how many of the companies following the practice of immediate write-off do so because of the United Kingdom example, how many do so because, as recent tax cases indicate, the law in Canada, like that of England, still regards these items as capital adjustments, and how many do so because of a feeling that this "conservative treatment is preferable.

As is pointed out in the American Institute bulletin, the argument that the practice of immediate write-off is conservative does not stand up on closer examination. Conservatism may be accomplished in the balance sheet but the effect on the income of later years is the reverse. In view of the increasing recognition now given to the principle that the income statement is of relatively greater importance than the balance sheet, any procedure which depends for its justification on a "conservative" effect on the balance sheet is becoming harder to defend.

While the arguments that might be used to defend the immediate write-off of discount on funded debt on legal grounds have a certain validity at first glance, a careful review of the situation reveals that the legal view is really irrelevant under normal circumstances. This is certainly the case as far as the income tax law is concerned. The principle that the provisions of the tax laws should not affect accounting practices is well established. In fact, most accountants are prepared to argue that accounting practice should determine the tax laws rather than vice versa. This would appear to be equally true as far as general company law is concerned. While it is possible to imagine a situation in which the deferment of a portion of the bond discount combined with a policy of complete payout of earnings through dividends might result in a legal impairment of capital, it is hard to conceive of any more normal situation in which the accounting treatment of bond discount and issue expense would have any legal significance whatever. If this is the case, it would be proper to follow the principle that it is desirable, if possible, for the accounts to reflect the economic or business facts rather than the technical legal position.

There can be little doubt that, except in a few special circumstances, the price at which debt securities are bought and sold in Canada is determined on the basis of "yield" or "effective rate". Therefore, it seems only reasonable that the accounting treatment adopted should reflect this practice. When both the issuer and purchaser regard a 5% bond issued at 95 to yield 5.25% to maturity as equivalent to a 5¼% bond issued at par, sound accounting would appear to require the issuer to reflect identical costs in each case. This, of course, can only be done by amortizing the discount allowed in the former case over the life of the issue.

The relatively rare situations in which prices of debt securities are affected by factors other than the yield to maturity (defaulted securities which may trade on the basis of the expected capital recovery or convertible securities whose price may be determined by the market values of the equivalent shares would be examples) do not normally arise until the securities have been issued. The possibility that such situations might arise should not, therefore, influence the accounting practice of the issuer.

There are two generally recognized methods of spreading the discount over the term of the issue: the interest method and the straight line method. It is usually argued that the only theoretically accurate method of amortization is the interest method in which the effective rate of interest is applied to the effective net liability to obtain the charge for each period. When this method is used, the effective liability, originally the net proceeds of the issue, is considered to

increase year by year as the discount is gradually absorbed into expense. Accordingly, the annual charge for debt amortization also increases year by year as the security approaches maturity. This effect, while theoretically justified by the fact that "equity" of the creditors is increasing as the maturity date approaches, seems unreasonable to many people. Most authorities recognize that the interest method is a little too theoretical for practical use. This difficulty plus the very real technical difficulty of applying the method under many circumstances militates against its general adoption. As a result, the straight line method, in which the charge is distributed over the life of the issue in equal instalments, is recognized by these same authorities as an acceptable alternative. This is especially true since the difference in the effect of the two methods on the income statement is only material if the amount of the discount is very great and the term of the issue is relatively short.

A review of those cases in which debt discount and issue expense is written off immediately suggests that very often the failure to follow the recognized and approved practice is due not to ignorance or obstinacy but to very real difficulties in finding a rational basis for the calculation of the annual amortization. Because such problem cases appear to have received less attention than necessary to ensure general appreciation of the difficulties and of possible solutions, a few special situations are discussed below. This summary is not, of course, intended to be a definitive outline of the generally accepted practices under these conditions. It is only an attempt to direct attention to the problems in the hope that with further discussion and consideration some generally accepted conclusions may be developed.

There are four types of long-term debt securities which seem to cause the greatest difficulty. These are: issues callable prior to maturity, serial issues, sinking fund issues and convertible issues. While to some extent the problems are interrelated because in each case the basic problem involves the uncertainty of the period over which the discount and expense is to be amortized, there are enough differences to warrant separate treatment.

1. Issues Callable Prior to Maturity

In the simple case of an issue which is callable only a few years before the nominal maturity, it is the usual practice of bond traders to calculate the yield as if the earliest call date were the maturity date. Under these circumstances, it may not be unreasonable for the issuer to follow a similar practice. On the other hand, the issuer, being in a position to determine when the bonds will actually be called, does not have the same need to ensure that all of the discount is amortized before the first possible redemption date. The use of the full term as the amortization period can thus be justified in many cases especially if it is reasonable to assume that the securities will be allowed to run to maturity. Even if the securities are redeemable after a fairly short period, the use of the full term can often be justified on the same ground especially where there is a substantial penalty premium required in the event of premature redemption.

2. Serial Issues

Where the securities maturing on each date are sold separately, there will be no problem as to the amor-

tization rate; each maturity can be computed separately. If, as is more likely, the unit of sale consists of blocks of varying maturities, a more involved calculation is required. In the latter case, assuming that the effective interest rate for each maturity is the same, the average rate for the whole issue can be applied to obtain the annual amortization by the interest method. Alternatively, a reasonable approximation can be obtained by an adoption of the straight line method in which the total discount and expense is allocated between years in proportion to the amount which will be outstanding at the end of each year.

If the variation in terms is so great that it is unreasonable to regard the effective interest cost as the same for all maturities, separate calculations for the long, short, and medium-term issues can be made. This can be accomplished by using separate interest rates derived from the average rate by the application of the current differentials as reflected in the securities market.

3. Sinking Fund Issues

Sinking fund issues, in which a specified amount of the issue is to be purchased or called for redemption each year until maturity, can be considered to offer the same problems as serial issues and thus to warrant similar treatment. There are, however, certain differences which may make this treatment inappropriate in some cases. If, for example, it can be assumed that all the securities acquired for sinking fund will have to be called for redemption at par, it is obviously necessary to ensure that the amortization program is designed so as to leave no unamortized balance in respect of the securities redeemed. This assumption, however, is not always warranted because if there is an active market in the securities and the going rate of interest remains unchanged, securities will be available for sinking fund purchases in the market at a discount equal to the unamortized balance remaining in the accounts. Under the latter circumstances, the acceleration of amortization to avoid the "losses" which would occur on redemption at par will actually result in producing profits when the liabilities written up to face value by amortization are discharged at a discount.

4. Convertible Issues

Convertible securities create a problem not only because they are in effect redeemable at any time, but also because the choice of time lies with the holder, not the issuer. Under these circumstances it is obviously desirable, in order to avoid frequent special charges to surplus in respect of unamortized discount, to write off all the discount and expense prior to the first conversion date. On the other hand, if it can be argued that the sale price of a convertible debenture actually represents the effective interest cost (a questionable assumption in many cases), then the "net liability" actually represents the real equity of the holder at any subsequent date and is accordingly the actual consideration received for the issue of shares. As it is clearly improper to assign a value to shares in excess of the consideration received, it follows that, if the above argument is valid, discount must be amortized and the unamortized balance applied against the par value of the securities converted to arrive at the issue price of the shares.

From the foregoing review of the

present situation in Canada, the following conclusions appear:

1. Although there is general agreement as to the theoretical desirability of amortizing debt discount and expense in an orderly manner over the term of the issue, these items in practice are often written off immediately.
2. In at least some cases the theoretically desirable practice is not followed because of the very real difficulty of finding a reasonable basis for doing so in some special situations.
3. There is a great need for further study and discussion of these special situations in order that a foundation for generally acceptable solutions may be developed.

(*The problems relating to the balance sheet treatment of unamortized debt discount and expense and the disposition of these amounts on premature redemption or conversion will be discussed next month.*)

The Auditor's Judgment

Judgment is the most important element in the practice of auditing. An auditor moves toward the constant goal of a well-informed opinion held with personal conviction. His thinking must be individual and free, yet he must be completely assured his thinking is not warped by preconceptions or bias. In choosing the types and quantities of evidence that he will collect and in selecting the procedures and methods that he will follow, an auditor is exercising personal judgments. But he is responsible that these judgments are logical, considered and professionally competent.

Auditing judgment is not to be studied and learned as a separate subject. It is the outgrowth of mature understanding and perspective which must be gained by experience. It is rooted in a well-rounded picture of the nature and kinds of audit problems, evidence, procedure and verification methods.

—"Integrated Auditing" by S. W. Peloubet and Herbert Heaton; pub. by The Ronald Press Co., New York.

Edited by CAMPBELL W. LEACH, C.A.

Tax Review

Foreign Companies Carrying on Business in Canada

Over the past few years several articles have appeared in connection with the taxation of foreign companies doing business in Canada. The subject was again discussed at the annual C.I.C.A. conference in Montreal where R. DeWolfe MacKay, Q.C. presented a very interesting and informative paper. While certain of his remarks have been covered in past articles in this magazine and elsewhere, there was nevertheless considerable material which may be new and of interest to our readers.

In discussing a topic of this nature, it is necessary to refer to the basic rules which establish liability for tax. These rules are that a corporation resident in Canada is liable for tax on its world income and, if not resident, is liable for tax on income derived from carrying on business in Canada. As is often the case with simply stated principles, their practical application to particular situations is often difficult.

With respect to residence, the courts have established the rule that a company is resident where its central management and control are located and that, primarily, this will be where the directors reside and hold their meetings. The mere fact that a company is incorporated in Canada does not of itself mean that it is resident in Canada. In certain cases, a corporation may be resident in more than one country and also be subject to tax in other jurisdictions in which it carries on business. In such cases, the tax problems are often quite challenging.

The Income Tax Act does not define exactly what constitutes carrying on business but section 139(7) indicates that it is a very broad concept. Fortunately, however, the implications of this are usually restricted by Canada's tax treaties with other countries which provide that a corporation doing business in Canada will only be taxed if it maintains a permanent establishment in this country. Of course, maintenance of a permanent establishment as defined in the tax conventions does not necessarily mean that it is liable for tax on the profits derived from carrying on business in Canada. The profits must be reasonably attributable to the permanent establishment and thus would not include, for example, profits derived from sales and shipments made from an establishment in the foreign country. Furthermore, the term "permanent establishment" implies the existence of an office staffed and capable of carrying on the day-to-day business of the corporation and its use for such purpose, or it suggests the existence of a plant or facilities equipped to carry on the ordinary routine of such business activity.

Mr. MacKay felt that the mere maintenance of a bank account or the ownership of vacant land or income-producing property would not mean that a company was carrying on busi-

ness in Canada although it would be taxable upon the income which it derived from Canadian property.

Mr. MacKay went on to point out that a foreign corporation could carry on business in Canada in one of three ways. It could incorporate a subsidiary company in its own jurisdiction, incorporate a Canadian subsidiary or carry on business directly by itself. The main advantage of having a subsidiary incorporated in the foreign jurisdiction was thought to be the ability to segregate the Canadian income from domestic income and to permit the payment of dividends by the subsidiary without attracting Canadian withholding taxes. The main disadvantage of having a foreign subsidiary carry on business in Canada is that there is no means of deferring taxes in the country of incorporation where such taxes are in excess of the Canadian rate. Generally speaking, a foreign subsidiary is not advantageous.

The simplest way for a foreign corporation to carry on business in Canada is to do so itself directly. There is difficulty, however, in determining with any degree of certainty what profits are deemed to have been earned by it in Canada. While elaborate regulations exist under the Income Tax Act governing the allocation of taxes between provinces, no such regulations exist for determining the allocation amongst various countries. The normal formula adopted is to take the percentage of total profits earned by the non-resident company from all sources which sales or gross revenues derived from Canada bear to total sales or total gross revenues from all sources, subject to certain disallowances of expenditures wholly applicable to foreign business operations.

The foregoing allocation method is usually ignored where the branch maintains proper records of the business activities in Canada in such a manner that the profits truly earned in Canada can be established from its books. While this may be quite satisfactory in theory, it is often difficult to convince the taxation authorities that the branch profits have been properly determined, i.e. as if the branch were an entity dealing at arm's length with the foreign head office.

If no branch records are maintained, the profits deemed to have been earned in Canada are determined on an artificial and unreal allocation. For instance, if the overall percentage of profits of a non-resident company to sales in the foreign jurisdiction is lower than that reasonably attributed to sales made in Canada, the profit allocation to Canada is artificially low. Similarly, if the profit element in Canada is lower than in the home market, Canada is reaping an unearned tax by relating such profits to the profits earned outside Canada.

There are other disadvantages to a company carrying on business in Canada directly. One of these is that the non-resident company must file its own financial statements with the Canadian tax authorities and attach reconciliation statements thereto. Such a company must also take out an extra-provincial licence in each province in which it carries on business and, if it acquires real estate, probably a mortmain licence in each province in which it acquires real estate.

Mr. MacKay felt that most of these problems are avoided by the incorporation of a subsidiary in Canada. It was pointed out, however, that it is not sufficient merely to cause a Canadian subsidiary to be incorporated,

but that such subsidiary should always maintain the relationship with its parent of purchaser-vendor and not that of principal and agent. Despite the provisions of various reciprocal tax conventions which exclude a Canadian subsidiary from being a permanent establishment in Canada, Mr. MacKay expressed the warning that a non-resident could be deemed to be doing business in Canada if the subsidiary acts as an agent. This is a point which is often overlooked but which should not now be forgotten.

Having decided that the Canadian subsidiary is to have a relationship of purchaser-vendor with its parent, the problem of determining Canadian taxes becomes comparatively simple. Of course, certain provisions of the Canadian Income Tax Act must be observed, especially those of section 17 which provide that the price at which the non-resident parent sells goods or services to its Canadian subsidiary must be fair and reasonable. Ordinarily, the fair market price, as determined for the purposes of customs and excise duty and sales tax under the Customs Act, is accepted as the fair price but this is not always the case. With respect to management fees, which are often charged to the Canadian subsidiary, care must be taken that the management fee is not such as to be construed to be a discount or rebate on prices paid for goods sold since, if such inference could be drawn and established, the parent company would run into difficulties with the customs authorities. Under the Customs Act, the importer must make a sworn affidavit that it is not paying any discount or rebate, commission or other payment to the exporter which might be construed to be a reduction of the fair market value.

Another problem that must be carefully considered occurs when the operations of the Canadian company are carried on at a loss, which often happens during the initial stages. There is no objection from a tax point of view for the non-resident parent to contribute funds sufficient to offset the deficit. However, if it takes the form of a forgiveness of current indebtedness payable to it, there may be the danger that such forgiveness will be construed as a reduction of price for goods purchased or services received, particularly if such forgiveness is made periodically. In this connection, reference is made to the Tax Review department of *The Canadian Chartered Accountant,* September 1958 where the tax cases of Oxford Motors and Plimley Automobile were discussed under the heading "Merits of Tax Planning".

Having decided that the best method for a non-resident company to carry on its business in Canada is through the medium of a subsidiary company, a further question arises as to the manner in which the Canadian company is to be set up. Should it have its capital requirements provided by subscription to equity stock, common or preferred, is it to be by way of loan, funded or otherwise, or for that matter is it to be provided by way of a donation from the parent company? Mr. MacKay pointed out that, in his view, a complete financing through common stock is too fixed and inflexible in that the non-resident cannot obtain a return of the original investment and that the initial profits of the subsidiary bear the full tax burden immediately. In order to maintain flexibility, which is considered fairly important, it would seem better for the equity capital to be provided by a nominal amount of common shares

and the balance, or real capital, to be provided by subscription to redeemable preferred shares or by loan capital. The preferred shares do not have to be redeemed until it becomes advisable to do so and dividend payments may be withheld so long as it is desired to plough back earnings into the business of the subsidiary. There are, however, certain limitations on the issue of preferred shares as they cannot be issued at a discount or redeemed at a premium without involving difficulties. Furthermore, in certain foreign countries difficult tax problems sometimes arise upon the redemption of preferred shares. Mr. MacKay went on to point out that, with respect to the common shares, it is preferable that they be of no par value.

On the assumption that it is desirable for the parent to recover its original investment by the method that attracts the least immediate tax burden in Canada and to ensure that, in the event of financial reverses, the parent company may recover at least a portion of its investment, the best way to accomplish these objectives is for the parent company to provide the major portion of the capital requirements of the subsidiary. This it may do by way of loan, either on open account or represented by notes payable on demand or at a fixed term, and possibly even funding the indebtedness and having it secured on the assets of the company by means of debentures or bonds. Interest on the loan may be deducted from income for Canadian tax purposes but of course is subject to the 15% non-resident tax unless the money is borrowed from a bank or other person with whom the Canadian subsidiary is dealing at arm's length and the principal and interest are payable in a foreign currency. In this event, however, care should be taken to see that the bank or other lender is acting as a principal and not as an agent for the parent company.

In summing up, Mr. MacKay expressed the opinion that, unless there are special problems involved which require special treatment, it is most advisable for a non-resident corporation contemplating doing business in Canada to do so through the medium of a wholly-owned subsidiary Canadian company. The principal advantages of a separate Canadian subsidiary are flexibility in determining the true profits derived from Canadian operations, and the deferment of the excess tax, if any, payable in the jurisdiction of the non-resident parent company where taxes in that jurisdiction exceed, as is often the case, the taxes at the rates imposed in Canada. Such a company should be set up with a nominal capital consisting of no par value shares and its capital requirements provided by way of a loan, possibly from a bank or other lender with whom the Canadian subsidiary deals at arm's length.

The Canadian subsidiary so set up would normally purchase its capital and other assets with borrowed money and, if acquired from the parent company, should be at the fair value thereof as determined for customs purposes. If, however, the Canadian subsidiary is to acquire its assets for shares, the consideration should either be in no par value shares or, if for par value shares, at an aggregate par value equal to the fair market value of the assets acquired.

The parent company could, if it so desires and the circumstances warrant it, require the payment of a reasonable management fee. The man-

agement fee would normally cover the time expended by the parent company personnel on the affairs of the Canadian subsidiary, and could include fees for technical information, data and know-how. Care should be taken, however, to ensure that the management fee could not be construed to be a discount or rebate as mentioned previously or in the nature of a royalty or other similar payment for the use of intangible rights in Canada. If the Canadian company is operating under a patent or other similar right, it would be well advised to purchase the Canadian rights from its parent company for a fixed amount, even if payable over a period of years. Such payments are capital payments and would normally be covered by depreciation, whereas direct royalty payments (including the purchase price of the patent if it is not a fixed and determinate amount) would bear the burden of a withholding tax of 15% on the gross payment.

The Canadian company should also acquire its own real estate rather than have the parent company purchase real estate in Canada and rent the property to the subsidiary. Not only would rentals be subject to the 15% withholding tax but there would be a risk that, because the parent company had real estate or other assets in Canada, it would be deemed to be doing business in Canada and to have earned a profit on the business which it conducts with its Canadian company.

RECENT TAX CASES

Holding Company Expenses

The capital of the appellant company was invested in shares of and loans to subsidiary companies from which it derived both dividends and interest. As the dividends were exempt from tax and represented about 95% of the company's gross income, the Minister disallowed 95% of the company's expenses contending that they were incurred to earn income which was not taxable. The Income Tax Appeal Board upheld the Minister, but the assessment was varied when dealt with by the Exchequer Court. The Exchequer Court segregated the expenses into three categories, those relating to transactions with shareholders (stock transfer expenses, listing fees, cost of the annual report and proxy expenses) which were definitely not allowed, those relating to the earning of interest income which were allowed in full, and general expenses which had to be dealt with in some arbitrary manner. The Court felt, however, that the arbitrary method used by the Minister was not the most suitable. Instead of prorating these general expenses on the gross revenue basis, it ruled that they should be prorated on an asset basis. In other words, the proportion which the appellant's investment holdings in shares bore to its total investment holdings could reasonably be regarded as the extent to which the expenses were incurred to produce exempt income. (*Distillers Corporation Seagrams Limited* v. *M.N.R.*)

It is interesting to note that, in addition to upsetting the time-honoured proration according to gross revenue, the Court ruled that the deduction of certain normal business expenses was prohibited *in toto* by section 12 (1) (a). The expenses in this category were legal advice for stockholders, stock transfer expenses, stock exchange listing fees, printing and stationery in connection with the annual meeting of shareholders, and

proxy expenses. They were, ruled the Court, "expenses which must be incurred by a corporation whose shares are listed on the stock exchanges, but they are incurred in the course of the appellant's dealings with its own shareholders as shareholders and in connection with the administration incident to the capital structure and arrangements of the appellant, rather than in carrying out activities which form any part of the business or process or function or means by which the appellant's income is gained or produced." It is wondered whether this aspect of the judgment will be extended to other corporations.

A Nice Distinction

In this case, also heard by the Exchequer Court, a company had sold all of the assets of one of its divisions and in so doing realized a profit upon the inventory of the division. The transaction took place before the introduction of section 85E and the Income Tax Appeal Board ruled that the profit was a capital receipt upon the sale of a portion of the company's business. The Exchequer Court agreed that the sale was a transaction outside and beyond the scope of the company's business. However, it ruled that at the moment it was disposed of, the inventory was trading stock on which a potential profit had been earned in the trade. This potential profit was realized when the company diverted the inventory from the trade for the purpose of disposing of it in a transaction beyond the scope of the trade! The realizable value of the inventory so diverted had to be brought into computation of the profit as a receipt for the period in which the diversion occurred. (*M.N.R.* v. *Frankel Corp. Ltd.*)

Salary Not Received

The appellant was president, manager and controlling shareholder of a private company and received a fixed salary. In 1954 he received only a part of his salary in cash, the balance being credited to him in the books of the company. The Minister attempted to tax him upon the salary credited and not received but was reversed by the Income Tax Appeal Board. It ruled that a taxpayer is taxable on the salary received by him in the year, that is to say, on what he is paid in cash or otherwise, provided the funds come into his possession. The fact that the amount of salary owing to the appellant had been credited to him could not be considered payment within the meaning of the Act. (*Claude Rousseau* v. *M.N.R.*).

In a previous case (*Robert Roy Cliffe* v. *M.N.R.*) the same conclusion was reached but there was no evidence that the amount owing had been credited to an account in his name on the company's books. Evidently, a specific credit to an individual's account need not now be regarded as equivalent to "received", which ought to open the door for tax deferment.

Cash Discounts

The appellant company provided for the cash discounts which it expected would have to be given in respect of sales made during the last month of its fiscal year and claimed the deduction for tax purposes. The deduction was disallowed by the Income Tax Appeal Board on the grounds that the provision for discounts was a reserve or contingent account, the deduction of which was prohibited. (*Crane Limited* v. *M.N.R.*).

BY JOHN W. CROWE, C.A.

Administrative Accounting

Inventory Management

The objective of inventory management, like the objective of all financial planning and control, is to maximize profits.

It is always much easier to state a goal than to attain it. As in most practical problems, determining and maintaining an optimum level of inventories involve the reconciliation of conflicting interests. Of the many factors which must be considered in controlling inventories, some continually operate in favour of expansion while others are on the side of contraction. Perhaps the main factors favouring large inventories are as follows:

1. Improved service to customers and avoidance of shipping delays due to plant breakdowns.
2. Avoidance of plant shutdowns through running out of stocks of raw materials, spare parts, etc.
3. Economy of long runs particularly where a number of products are processed on the same equipment.
4. Avoidance of overtime and sharp variations in employment through a levelling of production.
5. Reduction in plant investment where the demand varies materially or where there is a marked seasonal variation.
6. Where total costs are almost fixed, as in some petrochemical plants, there may be justification for a high level of production irrespective of immediate sales requirements.

By far the most important advantage in curtailing inventories is the releasing of financial resources for more productive uses. Accountants usually think of inventories as being "current" assets. For a going concern inventories are often more "fixed" than buildings and equipment. Money invested in the latter is continually being recovered in the form of depreciation during the life of the facilities. On the other hand, funds invested in inventories may be "frozen" for as long as the company remains in that line of business. It follows (notwithstanding profit statements to the contrary) that the full amount of any continuing reduction in inventories is in a practical sense a real cash saving to a company. Moreover, it is a non-taxable saving.

Other factors favouring limited inventories include:

1. Reduction in storage facilities.
2. Reduction in warehouse operating costs.
3. Minimization of losses in obsolete and slow-moving items, and any items that deteriorate with age.
4. Greater flexibility in substituting new products or discontinuing products.

The determination of an inventory level which permits the maximum return on company investment involves consideration of all the factors referred to above and the development of an effective inventory plan. Recognizing the limitations of most sales forecasts, the plan must be flexible

and provide for self-correction, having regard for the ever changing facts of life.

Responsibility

Perhaps the soundest ground on which to base industrial accounting is to report on the activities and responsibilities of individuals. When these activities fail to measure up to company plans or standards, the situation can be brought home to those who are in a position to do something about it. This approach, for example, works very well in accounting for sales and selling expense. The sales manager is naturally anxious for his sales to meet company objectives and for his selling expense not to exceed his budget. He knows that if he fails to meet the company plan in either respect he will have to explain. Similarly a production manager is accountable for costs and quality of production. If either is off standard it will show up like a sore thumb in monthly internal financial reports.

Controlling inventories, unfortunately, seems to be a more difficult problem than controlling sales or production costs. The reason is that it is difficult to put a finger on any one person who has authority and time to do something about inventories and whose predilections in the matter do not conflict with overall company interests. Production of finished goods is normally geared directly to meet the requirements of the sales manager. He therefore is often in the best position (from an organizational point of view) to control inventories of finished goods. However, his prime objective must of necessity be to sell, and the more finished goods of all variety he has on hand, the less is the likelihood of missing a sale. Only as a secondary consideration is he likely to direct attention to the amount of company funds being unnecessarily frozen in idle inventories. Moreover, a production or works manager is often the person directly in charge of stocking raw materials, spare parts and stores. Again the prime interests of this manager is certainly not in controlling inventories, but rather to manufacture at the lowest practicable cost and, in particular, to maintain continuous production. As regards inventories of raw materials, he almost inevitably has a bias in favour of large stocks. His main fear is of running out of some item which will stop production.

Nevertheless, any successful plan to control inventories must enlist the active participation and support of the sales, production and works managers. There must be overall company standards within which these individuals can plan and act.

Who should draw up the company standards or overall inventory policies? A fairly common device is a management committee on inventories headed by the treasurer or controller and set up to investigate, advise and report. While this writer has no very high opinion of the efficacy of committees, it is obvious that a process of synthesis must be carried out. Someone or some group must reconcile sales, production and financial interests and produce a workable overall company plan for inventories. In a broad and intelligent sense the financial viewpoint (meaning the maximizing of company profits) must in itself mean a consideration of all the various interests involved and the consequent determination of the most satisfactory level of inventories. Normally, this viewpoint must be developed and expressed by the treasurer or controller. Whatever the organiza-

tional set-up, it would appear that workable composite inventory plans or standards can best be produced by the treasurer in close consultation with those responsible for sales and production. The standards must be flexible and must be based on sales and production facts. They must provide a framework within which production and sales managers can and will work.

Classifications

For the purpose of examining standards and developing rational explanations of requirements it may be helpful to classify inventories as follows:

1. Finished goods
2. Goods in process
   a) Bulk stocks
   b) Others
3. Operating materials
   a) Raw materials
   b) Packaging materials
   c) Power materials
   d) Processing materials
4. Maintenance materials
   a) Spare parts
   b) Mill supplies.

One feature of the above arrangement is a clear distinction between operating and maintenance materials. The advantage of such a distinction for purposes of control lies in the fact that consumption of operating materials generally varies directly with production whereas use of maintenance supplies generally does not. The classifications correspond to the usual division of responsibility at an industrial works.

Inventory Standards

In endeavouring to determine the optimum level for stocks of finished goods the essential facts to take into account are sales requirements and productive capacity. A very common device in measuring the coverage of stocks is to calculate the number of days requirements on hand, in other words, the turnover. In order to complete the picture it would appear essential to relate the finished goods on hand (and also monthly sales) to the number of days needed to produce them. For example, a low turnover of inventories (i.e. a high percentage of inventories to estimated sales) is often justified on the need to build up stocks to meet seasonal requirements. Relating both monthly inventories and estimated monthly sales to number of days (or months) production capacity makes it easier to assess the validity of such arguments.

In a business with many different products and grades combined with a widespread market, the problem of establishing inventory levels can be most complicated. It is almost obvious that every warehouse location cannot be stocked with sufficient materials to meet every conceivable sales demand. The line must be drawn somewhere. To err on the side of overstocking may, in frozen funds, cost the company much more than the profit on any possible sales. Techniques such as probability mathematics may be useful in determining the break-even point between the costs of carrying extra inventories and the loss of profit from losing a sale.

Bulk goods-in-process, almost ready for packaging, present the same problem of control because finished products and quantities on hand can usefully be related to productive capacity and future sales requirements. In many plants the level of materials required to be in actual process is mainly a production problem and may by no means vary proportionately

with the scale of operations. In any event, before standards can be set for materials in process, the physical conditions governing their level must be explored and understood.

The optimum level for inventories of raw materials (i.e. purchased materials to be processed into finished goods) will be largely a function of expected production levels and the suppliers' delivery times. It may be helpful to distinguish between those materials which have to be purchased in bulk (such as before the end of the shipping season) and those which do not. Again, the rate of turnover is the most common and probably most useful tool. For major materials this can be translated into terms of number of days production requirements which in turn can be related to the delivery time. Assistance of the company's general purchasing agent, if there is such an individual, is clearly essential in setting effective standards for inventories of raw materials.

In assessing the proper coverage for purchased materials, goods on order are often lumped together with actual inventories. This is clearly wrong. In some cases, it may be desirable, or even essential, to order materials for months in advance. Extended orders, while certainly commitments against the company, do not tie up funds or incur handling costs until the goods are actually received.

Consumption of packaging and power materials generally varies with production, and the control will be similar to that for raw materials. Processing materials, i.e. materials which are used in the process but do not enter into the finished product, often present a different problem. Examples are catalytic agents and refrigeration materials. In general, consumption does not vary directly with production and the problem of standard inventories must be specially investigated.

Spare parts may account for an important portion of the investment in inventories at an industrial works. Obviously, this is a fruitful field for examination in any effort to reduce inventories. If the practice of carrying replacement parts were carried to an extreme, a whole plant might be largely duplicated to avoid the contingency of a possible shutdown. This would clearly be nonsense. No possible loss of profit during a shutdown waiting for a new part could possibly justify freezing such extremely large sums in inventories. The problem is where to draw the line. In the petrochemical field where high pressure specialized parts often come from single suppliers in England or United States the question may be particularly vital. Experience and probability mathematics (along the line of "operations research") may be useful to determine the border line. Once more it should be noted that a reduction of, say, \$100,000 in stocks of spare parts is an addition of \$100,000 to company resources and is really a long-term saving of that amount. If spare parts are carried in inventory, they are more "fixed" than installed equipment since they are probably not being recovered by way of depreciation.

Maintenance mill supplies may consist of thousands of items but usually amount to a relatively very small proportion of the total value of inventories. Accounting and control for such supplies should be drastically simplified so that time and intelligence can be directed to those materials which really cost money.

Planning and Reporting

Using the tools discussed above and any others that are workable, applicable standards or plans should be drawn up annually for the inventories of each works or division. Basically, the inventory plan or budget should be made an integral part of the company's scheme of planning for profit. In fact, it would appear to be impossible to plan sales and production without delving into the problem of inventories.

As with other budgets or reports, the annual budget of inventories should be prepared in a pyramid fashion. The budget going for approval to top management should give a simple overall picture of inventories in relation to projected sales and production, all being tied into the annual profit budget. Supporting the overall plan should be more detailed studies by major product. These studies are meant for practical day-to-day operations, but are also available for top management if it requires more extensive background along any particular line. After approval of the overall flexible inventory budget, sales and production managers must request specific authorizations for any major departures from the plan.

The treasurer's department will compare actual performance with the inventory budget monthly or quarterly. Only major variations and explanations need be brought to the attention of top management.

Essentially the biggest problem in controlling inventories is that the people in the best position for control usually have more compelling and often conflicting interests. To plan and watch over this area requires outside guidance in addition to that exercised by those in sales and production. The guidance can be best provided by the treasurer or controller.

BY PETER C. BRIANT, M.B.A., C.A.

Current Reading

MAGAZINE ARTICLES

AUDITING

"AUDIT TECHNIQUES FOR ELECTRONIC SYSTEMS" by D. M. Shonting and L. D. Stone. *The Journal of Accountancy,* October 1958, pp. 54-61.

To the extent that source documents are checked, verified, transcribed, and filed as they were before data was processed electronically, there is no basic difference now in the audit of records produced electronically, compared with those previously used. The auditor may be able to begin an audit of a newly changed process with a careful comparison of the new and former practices. On other occasions, the changes will have been so great that to start the review of new procedures with a study of the old will prove more of a handicap than an aid.

The major adjustments in audit techniques required to accommodate the analyzing, recording and filing of accounting data include:

1. Recognize the increased importance of input data. Under electronic methods there may be no human intervention from point of input to the final report of decision made by the machine. The capacity and training of the personnel handling and converting the data and operational controls over them are thus of vital importance.
2. Assure the accuracy of electronic data processing machine operations by using the machine itself, under specially developed programs, to audit the installation records, particularly the data which it processes.
3. Study new filing methods to insure that source information can be easily located and identified, and is readily available for print-outs of the types of information needed in the course of the audit.
4. Encourage internal auditors to conduct a continuous and timely appraisal of data processing.

As changes in E.D.P. evolve, the auditor will need to be constantly alert to the dangers to his audit trail. He may find it necessary to insist upon preparation of data two ways: conventionally for the files, and in machine language for processing. Flexibility and receptivity to change is a prime requisite to performing an effective audit of an electronic data processing system.

"PRACTICAL IMPROVEMENTS IN AUDIT TESTING" by M. A. Schwartz and L. N. Teitelbaum. *The Federal Accountant,* September 1958, pp. 20-34.

The practical use of statistical sampling methods is illustrated in this article by a case study of the audit of the shipping function at U.S. Air Force depots.

On the basis of samples of 224 vouchers in depots whose universe ranged from 12,000 to 232,000 vouchers, the audit objective (to determine the efficiency of off-base shipment operations at each major depot during a complete month of operations) was fulfilled. Scientific discipline throughout the program produced

uniform results, state the authors, and audit reports were improved. Participating auditors felt that the program "definitely increased the confidence factor available to the auditor" and "provided a better basis for substantiating conclusions stated in the audit report." They also commented that "the findings from this comparatively small test corroborated conclusions of prior tests which were obtained from considerably larger sample sizes. . . ."

DISTRIBUTION COSTS

"The Increasing Overhead Burden" by C. C. Smith. *The Australian Accountant,* July 1958, pp. 331-334.

We have a position today, writes C. C. Smith, where production cost is but a minor portion of the elements constituting the price of a product to the ultimate consumer. He estimates that other costs boost the original production cost from four to five times depending on the product.

In this analysis, Smith misses the point: the relationship of other costs to production costs is of far less importance to the consumer than the trend of total cost in relation to quality and convenience. An increasing ratio of distribution costs to production costs is an unavoidable concomitant of the expanding economy. Mass production must be production for the masses, and selling to the masses requires intensive and extensive market cultivation, both of which become progressively more costly as output per capita increases.

LAW

"Liability of Auditors" by Ralph E. Kent. *The Journal of Accountancy,* September 1958, pp. 61-66.

Following a review of certain of the legal liabilities and other adverse consequences that may arise in an accounting practice, Ralph E. Kent makes ten suggestions designed to minimize the risk to which the auditor is exposed:

1. Keep uppermost in mind the essential requirements of independence and integrity.
2. Have the facts and take the time to reach considered opinions.
3. Make sure your work papers are reviewed carefully and completely.
4. Beware the menace of hindsight wisdom; develop imaginative and creative thinking which keeps in mind that developments in the future may be adverse.
5. Improve the record on internal control work.
6. Review carefully the additional information in a long-form report when a short-form report has also been issued.
7. Be informed as to developments in the application of statistical methods to the testing technique used in auditing work.
8. Continue the efforts to improve and clarify statements of principles and standards. These establish for the courts the nature and extent of the accountant's responsibility.
9. Proceed with extreme caution in auditing finance companies extending relatively large amounts of credit to individual customers. In four leading cases, the accountants' errors, alleged or actual, were found in or associated with receivables. In three of these cases, the clients were engaged in financing business ventures of others.
10. Carry accountants' indemnity insurance.

Adherence to the principles and standards formulated by the professional societies will help avoid troublesome situations, Mr. Kent advises, and provide the practitioner with the most effective defence should a defence become necessary.

MANAGEMENT

"THE DANGERS OF SOCIAL RESPONSIBILITY" by Theodore Levitt. *Harvard Business Review,* September-October, 1958, pp. 41-50.

Raising a dissenting voice against the increasing calls for business management to forget that they must be businessmen first and to accept more social responsibility, Mr. Levitt, a marketing and economic consultant, writes as follows:

> Business will have a much better chance of surviving if there is no nonsense about its goals — that is, if long-run profit maximization is the one dominant objective in practice as well as in theory. Business should recognize what government functions are and let it go at that, stopping only to fight government where government directly intrudes itself into business. It should let government take care of the general welfare so that business can take care of the more material aspects of welfare.
>
> The results of any such single-minded devotion to profit should be invigorating. With none of the corrosive distractions and costly bureaucracies that now serve the pious cause of welfare, politics, society, and putting up a pleasant front, with none of these draining its vitality, management can shoot for the economic moon. It will be able to thrust ahead in whatever way seems consistent with its money making goals. If laws and threats stand in its way, it should test and fight them, relenting only if the courts have ruled against it, and then probing again to test the limits of the rules. And when business fights, it should fight with uncompromising relish and self-assertiveness, instead of using all the rhetorical dodges and pious embellishments that are now so often its stock-in-trade.
>
> . . . Businessmen complain about legislative and other attacks on aggressive profit seeking but then lamely go forth to slay the dragon with speeches that simply concede business's function to be service . . . the fact is, no matter how much business "serves", it will never be enough for its critics. . . .

PROFESSIONAL

"MANAGEMENT SERVICES BY LOCAL PRACTITIONERS" by Perry Mason, *New York Certified Public Accountant,* October 1958, pp. 707-712.

The problem facing the local practitioner attempting to offer management services to his clients can be aptly summed up by Adam Smith's famous dictum that "the division of labour is limited by the extent of the market". Management services, in contrast to auditing, are a specialized function. Rarely, in a small town, will the demand for these services be large enough to warrant a local firm keeping a full-time specialist on its staff. But the need for these services is increasing so rapidly that the local practitioner now finds himself forced to expand into areas that are often outside his range of competence.

In addition to developing specialties of his own within a limited range (e.g. forecasting and budgeting, systems installation, and cost accounting), the local practitioner can meet the problem by calling in non-accounting professional firms or, more desirably, other accounting firms. Co-operation between local firms would be extended, suggests Perry Mason, research associate with A.I.C.P.A., if the practitioners were to advise each other of the types of services each is qualified to handle. Referrals to large firms would be furthered if the large firms would take the initiative in the matter. He would like to see them notify the smaller firms of the types of services they have to offer, describe their fee structure, indicate how they would split the fee with the local firm, and assure the

latter that under no circumstances will they extend the work beyond the specific engagement. So far, according to Mr. Mason, there has been no report of any large firm doing this.

"ADMINISTRATION OF A CPA PRACTICE" by Max Block. *The New York Certified Public Accountant,* October 1958, pp. 747-749.

Here are some aids, suggested by Max Block, to improve the memory power so essential to a mastery of all the provisions of the Income Tax Act:

1. Pay close attention to whatever you want to remember.
2. Talk and think over what you have seen, heard, or read, as often as you can.
3. Writing out, underlining, and note taking are less effective than reflection and talking about the things you want to retain in your memory.
4. Associate a new fact with one well known to you.
5. The will to remember must be manifested as information is being received.
6. The use of alcohol slows down the memory function.
7. In arranging a day's activities, remember that powers of retention weaken as the day progresses.

SYSTEMS

"ADAPTING A WORK-IN-PROCESS SYSTEM INVENTORY TO PUNCHED CARDS" by R. D. Lamphere. *Cost and Management,* September 1958, pp. 312-317.

This article describes how the mechanization of its work-in-process inventory on punched cards enabled a company to obtain, at a relatively small cost, a wealth of detailed information which gave it greater control over its production costs.

The work-in-process inventories are now maintained on a deck of approximately 100,000 punched cards which are up-dated weekly or monthly. From this deck comes all information necessary to prepare financial reports, cost reports and invoices.

The new installation, which provides the detail for the estimating and cost control functions, provides an efficient means of assimilating, summarizing and presenting in greater detail many times the quantity of information previously carried on hand ledgers with no increase in personnel. Mr. Lamphere advises any company which now has or is contemplating the use of electronic tabulating equipment not to overlook the advantages of this method of maintaining work-in-process inventories.

RD INQ

BOOK REVIEW

Deloitte & Company, 1845-1956; University Press, Oxford: 171 pages, privately printed.

This book is a history of the firm of chartered accountants whose Canadian branch is Deloitte, Plender, Haskins & Sells and is the work of two partners of the firm. The initial research was undertaken by Mr. James Kilpatrick and was continued by Sir Russell Kettle who finished the book when ill health forced Mr. Kilpatrick to relinquish the task.

Handsomely produced, with many fine illustrations, it has a quality which sets it entirely apart from a dry-as-dust company history. The records which the authors had at their disposal must have been quite unusually detailed and have been skilfully handled to present the story of the development of the firm and the profession of chartered accountancy

against a background rich with human interest.

When William Welch Deloitte, grandson of a French Count, set up in practice in 1845, chartered accountancy was not the highly respected profession that it is today. It depended, in the main, on insolvency work, and today's strict code of conduct had yet to be formed. From the first, the firm seems to have prospered, and Mr. Deloitte originated a widely adopted system of hotel account keeping and investigated two of the great business frauds in England of the latter 19th century. He also took great interest in the formation of the Institute of Chartered Accountants in England and Wales, of which body in 1889 he was elected president.

Throughout the book, the authors have been most successful in showing how accountancy is connected with the hurly-burly of life and presenting the representatives of their firm as interesting flesh and blood personalities. As the firm expanded and opened branches in other countries, its business became so widespread as to be virtually a financial history of the past century. Some of the extracts from directors' reports have an amazingly contemporary ring about them, notably that of the Savoy Hotel in London whose directors attributed their inability to pay a dividend in 1890 to a formidable and familiar combination of ills: bad weather, business depression and an epidemic of flu.

"Deloitte & Company" was printed privately for Deloitte, Plender, Griffiths & Co., but it is hoped that many accountants will have the opportunity of reading it. In relating the history of a well-known firm, it gives a vital and fascinating picture of the profession over the past 110 years. R.E.

BY J. E. SMYTH, F.C.A.
Associate Professor, Queen's University

Students Department

PROBLEM 1

Intermediate Examination, October 1957

Accounting II, Question 3 (20 marks)

During the course of a student discussion group on the shareholders' equity section of published annual financial statements, you have been asked the following questions:

(i) What does the shareholders' equity represent?

(ii) What is the purpose of the classification of the components of the shareholders' equity under the main headings "Capital stock" and "Surplus"?

(iii) What is the difference between the terms "Par value", "Book value" and "Market value" used in referring to a share of capital stock?

(iv) What are the distinguishing characteristics of preferred shares and of common shares?

(v) What are the two main sources of surplus and why is it important that surplus items be segregated and classified according to these sources?

(vi) Why should "reserves" be included as part of the shareholders' equity?

Required:

Your answer to each of the above questions.

A SOLUTION

(i) *Shareholders' equity* as presented on the financial statements discloses the interest which the shareholders have in the total assets of the company. As such, it can be expressed in the formula "Shareholders' equity = Total assets – total liabilities". Its detail constitutes an explanation of the various ways in which shareholders have contributed to the total assets through capital stock (preferred and common), contributed surplus and earned surplus (including appropriations described as reserves). Where preferred share capital is outstanding, the concept of shareholders' equity requires for its full understanding a disclosure of whether the preferred shares are redeemable and, if so, at what prices, and if they are in arrears as to dividends, a statement to that effect.

(ii) *The purpose of the classifications "capital stock" and "surplus"*
The amount described as capital stock depicts that portion of the contributions made by owners which the company is expected to maintain intact for the protection of creditors. In general, other increases in

shareholders' equity over and above this amount may then be classified as surplus (contributed and earned).

(iii) *Par value* is the amount shown on the face of a par value share certificate and is a part of the description of such capital stock, as authorized in the company's charter. Its significance is determined by companies legislation governing the minimum amount of assets which the company may receive from subscribers to such shares when they are issued by the company.

Book value represents the recorded net assets attributable to each share of stock. It is calculated by dividing the total shareholders' equity by the number of shares issued and outstanding.

Market value is the price which a willing buyer will pay for shares when purchased from a willing seller. After the shares have been issued by the company, their market value is established independently of their issue price, by trading in the market.

(iv) *The distinguishing characteristics of preferred shares and common shares*

Common shares are a measure of ownership in a limited company. Each share represents a proportionate interest in the total shareholders' equity after deducting the amounts specifically attributable to preferred shareholders, if any.

Preferred shares carry certain rights as a term of their issue which take precedence over the rights of common shareholders, and may also be subject to restrictions which do not apply to the common shareholders. Preferred shares usually have a prior claim to dividends of a specified amount per share, if declared, and a prior claim to capital upon dissolution of the company. They are frequently limited as to the occasions on which their voting rights may be exercised. Unless they are "participating", their holders are restricted in dividend income to the extent of the specified preference dividend.

(v) *The two main sources of surplus*

Contributed surplus describes amounts paid in by shareholders in the form of premium on shares, any portion of the proceeds of issue of shares without par value not allocated to share capital account, profit on forfeited shares, proceeds arising from donated shares, and any other contributions by shareholders in excess of amounts allocated to share capital. The term may also be used to include capital donations from other sources as well, as for example, capital contributions in the form of governmental subsidies or building sites.

Earned surplus describes an increase in business assets which has taken place because a part of the increase in assets attributable to past profitable operations has been retained within the business (that is, not paid out in dividends). The concept of earned surplus includes gains on disposition of long-term assets and on the settlement of long-term debt or other liabilities.

Reasons for classifying surplus according to its sources

1. A logical distinction exists between assets received by way of direct contribution and amounts earned in the conduct of the business.
2. Surplus may arise from so many sources that a classification by source clarifies the meaning of all items called "surplus". Such a classification implies grouping items derived from the same source under a descriptive heading clearly indicating the source.
3. The classification compels some conformity in the use of the term "surplus".
4. Classification of surplus as to source in the financial statements may be required by companies legislation (for example, Ontario).

(vi) *Reasons for including reserves in shareholders' equity*

1. The term "reserve" is properly confined to a description of segregations of earned surplus. As such, reserves are created or increased by appropriations of retained earnings. Although the amount so appropriated is not available for distribution to shareholders, it remains a portion of their interest in the total assets of the business.
2. A reserve is a device for restricting for a specified purpose the disposition of surplus.

PROBLEM 2

Intermediate Examination, October 1957

Accounting II, Question 5 (21 marks)

Q, a fire insurance agent who started business on June 1, 1956, has asked CA to prepare financial statements for the year ended May 31, 1957. Although Q has not kept a complete set of books, he has operated an insurance trust bank account in addition to his general bank account. He has given CA the following summary of his banking transactions as shown by the bank statements:

	General Account	*Insurance Trust Account*
Balances in accounts:		
June 1, 1956	$ 1,974	nil
May 31, 1957	135	$ 826
Summary of cheques and transfers charged by the bank during the year ended May 31, 1957:		
Payments to insurance companies of premiums received from clients (less commissions deducted)		$30,675
Purchases of office furniture and equipment	$ 880	
Office rent	1,300	
Stenographer's salary	1,668	
Remittance of income tax deductions from stenographer's salary	110	
Purchases of unemployment insurance stamps	24	
Stationery and office supplies	265	
Advertising	251	
Personal expenditures	3,341	
Transfer of funds from trust account to general account		6,000

Summary of deposits credited by the bank during the year ended May 31, 1957:

Total deposits		$37,501
Transfer of funds from trust account to general account	$ 6,000	

CA ascertains the following:

(i) All deposits in the insurance trust bank account represent premiums collected from clients.

(ii) Two cheques drawn on the general account in May were outstanding as at May 31, 1957:

L Printing Co. — for office supplies	$43
M Clothiers — Q personal	$38

(iii) Insurance premiums receivable from clients at May 31, 1957 amounted to $8,647.

(iv) Payments to insurance companies during the year included $18 for insurance on Q's office furniture and equipment. The policy expired on May 31, 1957, and the commission rate applicable was 25%.

(v) Monthly statements from insurance companies showed that Q's indebtedness to them amounted to $5,427 at May 31, 1957.

(vi) At May 31, 1957, credit had not been received from the insurance company for an insurance policy issued and cancelled in May 1957. The client was credited with the full premium of $85, and the rate of commission applicable was 20%

(vii) Office rent amounted to $100 per month.

(viii) Employee's income tax deductions for the month of May, remitted in June 1957, amounted to $10.

(ix) At May 31, 1957, there were no unemployment insurance stamps on hand and the stenographer's unemployment insurance book was stamped up to date.

(x) An invoice for office equipment purchased in May, $150, was unpaid at May 31, 1957.

(xi) Depreciation on office furniture and equipment is to be provided at 10% of cost.

Required:

The statement of profit and loss for the year ended May 31, 1957 and the balance sheet as at that date. (Submit details of your computations.)

A SOLUTION

Q FIRE INSURANCE AGENT

Statement of Profit and Loss
for the year ended May 31, 1957

Revenue		
Commissions earned		$10,138.00
Expenses		
Stenographer's salary	$ 1,800.00	
Office rent	1,200.00	
Stationery and office supplies	308.00	
Advertising	251.00	
Depreciation on office furniture and equipment	103.00	
Insurance on office furniture and equipment	24.00	
Unemployment Insurance	12.00	3,698.00
Net profit for the year		$ 6,440.00

Q FIRE INSURANCE AGENT

BALANCE SHEET
as at May 31, 1957

ASSETS

Current		
Cash in bank		
General account	$ 54.00	
Trust account	826.00	880.00
Insurance premiums receivable		8,647.00
Prepaid expenses – office rent		100.00
		$ 9,627.00
Fixed — at cost		
Office furniture and equipment	$ 1,030.00	
Less accumulated depreciation	103.00	927.00
		$10,554.00

LIABILITIES AND PROPRIETORSHIP EQUITY

Current liabilities		
Accounts payable – insurance companies	$ 5,359.00	
– office equipment	150.00	$ 5,509.00
Employee's income tax deductions	———	10.00
Total liabilities		$ 5,519.00
Proprietorship equity — Q		
Capital introduced – June 1, 1956	$ 1,974.00	
Add net profit for year ended May 31, 1957	6,440.00	
	$ 8,414.00	
Less drawings during year ended May 31, 1957	3,379.00	
Capital – balance as at May 31, 1957		5,035.00
		$10,554.00

Details of Calculations

(1) Premiums on policies sold		
Deposits in trust account	$37,501	
Insurance premiums receivable	8,647	
Premium on own furniture and fixtures policy (4/3 of $18)	24	$46,172
Less		
Cost of policies sold		
Cheques on trust account to insurance companies	$30,675	
Owing to insurance companies	5,427	
	$36,102	
Less credit to come from insurance companies on cancellations (4/5 of $85)	68	36,034
		$10,138

(2) Stenographer's salary		
Cheques to her from general account		$ 1,668
Tax deductions remitted		110
Tax deductions not remitted		10
Unemployment insurance deductions (½ of $24)		12
		$ 1,800

(3) Office rent		
Cheques on general account		$ 1,300
Rent expense (12 x $100)		1,200
Rent prepaid		$ 100

(4) Stationery and office supplies		
Cheques on general account		$ 265
Unpaid supplies		43
		$ 308

(5) Office furniture and fixtures		
Cheques on general account	$ 880	
Equipment not paid for	150	
	$1,030	
Depreciation @ 10% on $1,030		$ 103

(6) Unemployment insurance stamps		
Cheques on general account		$ 24
Less recovered from stenographer		12
		$ 12

(7) General account bank balance – given		$ 135
Less outstanding cheques $43 and $38		81
		$ 54

(8) Due to insurance companies – their statement		$ 5,427
Less credit to come (4/5 of $85)		68
		$ 5,359

(9) Drawings		
Cheques on general account		$ 3,341
Outstanding cheque to clothiers		38
		$ 3,379

PROBLEM 3

Final Examination, October 1957

Accounting III, Question 2 (12 marks)

D and E entered into partnership on January 1, 1955 as manufacturers. The following assets were brought into the partnership:

	D	*E*
Cash	$ 1,000	$10,000
Fixed assets	18,000	–

It was agreed that E's business connections were worth $7,000 per annum to the partnership and that he should receive credit for three years' purchase of these earnings in addition to his cash investment. Profits and losses are to be shared equally by the partners.

Manufacturing started on January 15, 1955. The following information was extracted from the books of account for the period ended December 31, 1955:

Units produced	48,000 units
Units sold	35,000 units
Average selling price	$1.20 per unit
Cost of production	$38,400
General and administration expenses	$ 9,800
Partners' drawings:	
D	$ 1,000
E	$ 2,000

On January 1, 1956, additional capital was required to increase production and it was agreed that F should be admitted to the partnership on the following terms:

(i) Goodwill as at December 31, 1955 to be eliminated.

(ii) F to introduce $20,000 in cash and to receive a 50% interest in the new partnership, D and E's capital being unaffected by F's entry. Profits are then to be shared in the ratio of the partners' capital.

The following information was extracted from the books of account for the year ended December 31, 1956:

Units produced	90,000 units
Units sold	60,000 units
Average selling price	$1.15 per unit
Cost of production	$63,000
General and administration expenses	$19,960
Partners' drawings:	
D	$ 5,000
E	$ 6,000
F	$10,000

The closing inventory as at December 31, 1956 contained 3,000 units produced in 1955, all of which were considered saleable at prices which would show a profit.

Required:

A schedule to show the changes in the capital accounts of the three partners since the commencement of the partnership.

A SOLUTION

D, E, AND F

Capital Accounts for the Two Years Ended December 31, 1956

			D	E	F	Total
Capital balances January 1, 1955						
Cash and fixed assets			$19,000	$10,000	–	$29,000
Goodwill			–	21,000	–	21,000
			19,000	31,000	–	50,000
Earnings for 1955:						
Sales		$42,000				
Cost of goods sold @ .80c per unit		28,000				
Gross margin		14,000				
Expenses		9,800				
Profit		4,200				
			2,100	2,100	–	4,200
			21,100	33,100	–	54,200
Drawings, 1955			1,000	2,000	–	3,000
Capital balances December 31, 1955			20,100	31,100	–	51,200
Goodwill written off			10,500	10,500	–	21,000
			9,600	20,600	–	30,200
Cash introduced by F, January 1, 1956					$20,000	20,000
Goodwill credited to F					10,200	10,200
			9,600	20,600	30,200	60,400
Earnings for 1956:						
Sales		$69,000				
Cost of goods sold—						
Opening inventory	$10,400					
Cost of production	63,000					
	73,400					
Closing inventory— 3,000 @ .80c 40,000 @ .70c	30,400					
		43,000				
Gross margin		26,000				
Expenses		19,960				
Profit		6,040	960	2,060	3,020	6,040
			10,560	22,660	33,220	66,440
Drawings, 1956			5,000	6,000	10,000	21,000
Capital Balances, December 31, 1956			$ 5,560	$16,660	$23,220	$45,440

Editor's Comments: In the editor's opinion it can be argued that there is no goodwill to record on the introduction of F as a partner. F is prepared to pay only $20,000 for a one-half interest in the partnership; the whole business would therefore appear to be worth $40,000. Yet the books would show net tangible assets (including the $20,000 cash introduced by F) to be $50,200. The books would therefore seem to overstate rather than understate the value of the business as a going concern. Readers are invited to criticize or comment upon this reasoning.

PROBLEM 4

Auditing I, Question 1 (10 marks)

Intermediate Examination, October, 1957

State *briefly* why an auditor undertakes each of the following unrelated audit procedures:

(a) Examination of cancelled cheques and checking to cash disbursements record.
(b) Examination of the minutes of shareholders' and directors' meetings.
(c) Procuring of liability certificate from client.
(d) Test check of credit postings in accounts receivable ledger.
(e) Checking of cheques cashed in month subsequent to balance sheet date to bank statements.

A SOLUTION

Purposes of specific audit procedures

(a) The auditor examines cancelled cheques and checks them to the cash disbursements record to determine that the payments recorded in the cash disbursements book were actually paid out to the persons specified there. He also examines the cancelled cheques to ensure that the signatures are those of the proper signing officers.

(b) The auditor examines the minutes of shareholders' and directors' meetings to ascertain that the proper formalities have been followed in passing by-laws, electing directors, appointing auditors, approving annual accounts, appointing officers, and declaring dividends. His review of these minutes may provide information which is useful in examining the accounts, such as the remuneration of officers, approval of capital expenditures, long-term commitments, new activities, and important contracts.

(c) The auditor procures a liability statement from the client in order to have a statement in writing from senior officers of the client to the effect that they have no knowledge of any direct or contingent liability which is not known to the auditor or recorded on the books.

(d) The auditor test checks the credit postings in the accounts receivable ledger to ascertain that the postings are either for cash received from the debtors in the exact amount recorded or for properly approved credit notes or journal entries.

(e) The auditor checks the cheques cashed in the month subsequent to the balance sheet date to the bank statements to ascertain that no cheques issued during the period under review have been withheld from the auditor to cover a shortage or to discharge a liability.

NEWS OF OUR MEMBERS

Alberta

A. W. Berry, C.A. has been appointed secretary-treasurer of Northwest Industries Ltd., Edmonton.

Dennis F. Culver, C.A. announces the removal of his Vancouver office to Ste. 102, Alaska Pine Bldg., 1111 West Georgia St.

T. K. Fleming, C.A. has been appointed vice-president, finance of Balfour Guthrie (Canada) Ltd., Vancouver.

A. H. Jackson, C.A. announces that he has assumed the practice of F. W. Stevens & Co., in Langley.

I. T. Leslie, C.A. announces the opening of an office for the practice of his profession at 1272 West Pender St., Vancouver 1.

British Columbia

E. A. Campbell & Co., Chartered Accountants, Kelowna, announce the admission to partnership of Henry R. Hobson, C.A.

C. William Christian, C.A. and David R. L. Rolfe, C.A. announce the formation of a partnership for the practice of their profession under the firm name of Christian, Rolfe & Co., Chartered Accountants, with offices at Ste. 405, 850 West Hastings St., Vancouver 1.

Manitoba

Laird, Sprague & Co., Chartered Accountants, Brandon, announce the withdrawal from partnership of Daniel Sprague, C.A. and Edson Boyd, C.A., who will remain associated with the practice as consultants.

Nova Scotia

E. L. Pursey, C.A. has been appointed assistant to the vice-president, finance of Dominion Steel & Coal Corp., Montreal.

Ontario

John G. McD. Brown, C.A. has been appointed secretary-treasurer of Champion Savings Corp. Ltd., Montreal.

Jack Marmer, C.A. announces the removal of his office to Ste. 410, 160 Bay St., Toronto.

William H. Matthews, C.A. announces the admission to partnership of John C. Bates, C.A. Henceforth the practice of their profession will be conducted under the firm name of Matthews & Bates, Chartered Accountants, with offices at 19 Melinda St., Toronto 1.

Fred Skurka, C.A. announces the removal of his office to Ste. 310, 455 Spadina Ave., Toronto 5.

Martin K. Levinson & Co., Chartered Accountants, Ottawa, announce the admission to partnership of Joel L. Rubinovich, B.Com., C.A. and Gilles Portugais, C.A.

Grossman, Diamond & Goodfield, Chartered Accountants, announce the removal of their offices to 3130 Bathurst St., Toronto 19.

D. G. Scott, C.A. has been appointed comptroller of Dominion Steel & Coal Corp., Montreal.

Jack I. Hauer, C.A. announces the opening of an office for the practice of his profession at Ste. 3, 1142 Eglinton Ave. W., Toronto.

Quebec

Norman Cohen, C.A. announces the opening of an office for the practice of his profession at 5135 Western Ave., Montreal 28.

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Weinstein, Fox & Bessner, Chartered Accountants, announce the admission to partnership of Ronald E. Gallay, B.Com., C.A. and the removal of their offices to 5165 Sherbrooke St. W., Montreal.

H. W. Harris, B.Com., C.A. announces the removal of his office to 5135 Western Ave., Montreal 28.

De Coster, Normandeau & Cie, Chartered Accountants, announce the admission to partnership of Guy Gingras, C.A. Practice of the profession will be carried on under the firm name of De Coster, Normandeau & Cie, Chartered Accountants, with offices at 80 St. Peter St., Quebec.

OBITUARIES

We announce with regret the death of the following members:

WILSON, W. SYDNEY H. — partner in the Vancouver firm of Wilson & Wilson, in his 76th year, on October 28, 1958. Born in Ireland, Mr. Wilson was admitted to the B.C. Institute in 1921. Well known in Vancouver business circles, he was president and director of several companies including Georgia Hotel Co. Ltd. and Pacific Western Hotels.

BERTRAND, ROMEO — accidentally on October 11, 1958. Born February 8, 1907, Mr. Bertrand was admitted to membership in the Corporation of Public Accountants of the Province of Quebec in 1943 and to membership in the Quebec Institute in 1946. He was employed for many years with le Trust General du Canada and at the time was assistant general manager and treasurer of that company. He was a past president of the Graduate Society of l'Ecole des Hautes Etudes Commerciales de Montreal and a former member of the Council of the Quebec Institute.

LAIRD, WILLIAM C., on October 14, 1958 at Winnipeg, Manitoba, at the age of 87 years. Mr. Laird was admitted to membership in the Manitoba Institute in 1918 and continued the practice of his profession as a partner in Gilbert & Laird, Gilbert, Laird & Sprague and Laird, Sprague & Co., until his retirement from the latter firm in 1948.

INSTITUTE NOTES

B.C. INSTITUTE

***Eighth annual fall dance*:** The refurbished Louis XV decor of the Hotel Vancouver ballroom, together with luxuriant floral centre pieces for the cabaret style tables, lent a highly festive note to the eighth annual fall dinner dance of the B.C. Institute on Friday, Nov. 7, 1958. Representatives from the Vancouver Bar Association, the Law Society of B.C., the Certified General Accountants Association of B.C., the Society of Industrial and Cost Accountants of B.C., the Canadian Bankers' Institute and the U.B.C. Faculty of Commerce were guests of honour on this occasion.

***Students fall dance*:** The Institute of Chartered Accountants Vancouver Students Society held its annual fall dance in the Hotel Georgia Ballroom on Friday, November 28, 1958.

***Peace River C.A. Club*:** The Peace River Chartered Accountants Club, formed in Dawson Creek in 1957, held an annual meeting and election of officers at Grande Prairie, Alberta, over the Thanksgiving weekend.

B.C. members named to the 1958-59 executive included J. N. McPhail, Dawson Creek, past president, and J. Shutiak, Fort St. John, secretary-treasurer. Alberta members on the executive include Keith Adams, Grande Prairie, president and Alf Holm, Peace River, vice-president.

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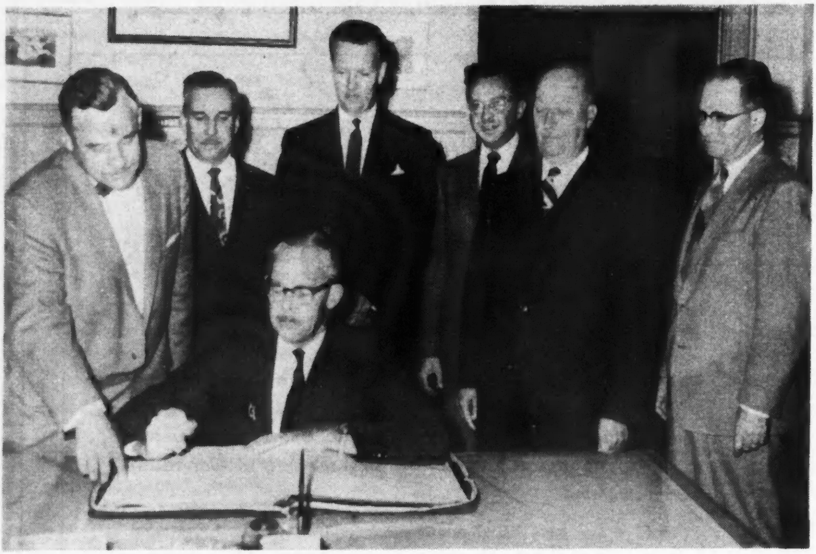

PRESIDENT WELCOMED TO MONCTON

John L. Helliwell, C.I.C.A. president, signs the city hall guest book at Moncton during a tour of the Maritime Institutes. Looking on from left to right are Ald. Sherwood Rideout, who welcomed the visitors in the absence of Mayor M. M. Baig, F. R. Blackmore, E. Michael Howarth, C.I.C.A. executive secretary who accompanied Mr. Helliwell on the tour, J. A. Marven, George Hudson and A. MacD. Cooke, city clerk.

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Vancouver Island C.A. Club: V.I.C.A. club activities for the 1958-59 season commenced with an informal gathering at the Pacific Club in Victoria on the evening of October 8, 1958 in honour of Sir Ian Bolton, a former president of the Institute of Chartered Accountants of Scotland.

At the annual general meeting of the club on Friday, October 24, 1958, the following members were elected to the 1958-59 executive: F. R. Brien, R. G. Campion, H. Frederiksen, R. McDougall (Nanaimo) and C. Webster.

Vancouver C.A. Club: International Woodworkers of American District President Joe Morris, speaking at the November 3 luncheon meeting of the C.A. Club of Vancouver, told members that labour circles viewed proposed B.C. labour legislation changes to bring about compulsory arbitration, compulsory incorporation of labour unions, a 72-hour strike action limit, and the enactment of a "right-to-work" law as an incitement to prolonged industrial and political disturbance rather than a measure to establish industrial peace.

A cocktail party has been planned at the Vancouver Lawn Tennis Club for December 5, 1958.

QUEBEC INSTITUTE

Forum Meetings: A series of forum meetings has been organized by a public relations sub-committee. On the premise that a majority of other Institute functions are of particular interest to members in practice, this forum series has been aimed principally at members in industry and is not restricted to members.

The initial forum was held on October 15 on the subject "Clerical Work Measure-

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ment". The panel comprised Richard Ganzi, president, Paul B. Mulligan & Co., management consultants, New York, N.Y.; Leonard R. Fertig, assistant to group vice-president, United States Rubber Co., New York, N.Y.; and Clifford H. Cheasley, manager of the employees relations section, Montreal Board of Trade. K. M. Place, C.A. was moderator.

The second meeting took place on November 12. The subject was "Putting Operations Research to Work" and the panel included L. J. Lacey, senior systems analyst, systems development department, Aluminum Company of Canada; R. A. McDougall, director, operations research, management advisory services, Price Waterhouse & Co.; and Dr. R. L. Martino, director, Univac computing service centre, Remington Rand Limited, Toronto. Peter S. Leggat, C.A. was moderator.

The third forum, scheduled for December 4, is on the subject "Management Engineering".

All these forums have been held in the Bell Telephone assembly hall, Beaver Hall Hill, Montreal, and gratifyingly large audiences have attended. The Institute deeply appreciates the courtesy of the Bell Telephone Company in making this room available.

Members of the forum are A. W. Bruce, chairman, W. R. Clerihue, A. H. Howson, J. Lacroix and J. S. McKeown. Mr. Lacroix is developing a program of forums in French, scheduled for early in 1959.

High School Officials Receptions: High school principals, vice-principals and guidance counsellors in the greater Montreal area were entertained in informal receptions in the Institute building on October 28 and 30. One reception was for English-speaking and the other for French-speaking guests. Members of the executive and public relations committees of the Institute attended. Each meeting included a brief review of Institute activities and a question period in which queries about the profession or the Institute were answered. The receptions were arranged by the Public Relations sub-committee on recruitment, consisting of R. G. Buckingham and Roger Charbonneau.

Dance: Tentative arrangements have been made for a St. Valentine's dance to be held in one of the leading Montreal hotels on Friday, February 6, 1959. Full particulars will be announced in due course. The dance committee consists of R. R. Jackson and W. R. Clerihue.

Provincial Conference: The third annual conference of the Quebec Institute will be held at McDonald College, Ste. Anne de Bellevue, P.Q., on June 14, 15 and 16, 1959.

Presentations: During the last few months presentations of silver trays commemorating 50 years of membership were made to John A. Grant and Walter W. Rathie. Mr. Grant became a member in 1907 and was for many years a partner in the firm of P. S. Ross & Sons. He is now retired. Mr. Rathie joined the Institute in 1908 and founded his own firm, now known as Rathie, Woodall & Winton. He has also retired from active participation in the practice. The Institute extends to both these

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members its heartiest congratulations and best wishes for many more years of continued interest in the profession.

Students Society: More than 250 couples attended the annual dance of the Students Society, held in the Champlain Room of the Sheraton-Mount Royal Hotel on October 24. The orchestra of Paul Beauregard provided music for the occasion.

ONTARIO INSTITUTE

Associate Registrar: The president, M. A. Bradshaw, has announced the re-appointment of Thomas Merrilees as associate registrar of the Institute on September 1, 1958. Mr. Merrilees returned from New Zealand at the request of the Institute to replace Mr. V. R. Wood who resigned at the end of August to return to public practice.

Affiliates: The following have been admitted by affiliation: M. E. Alflatt (Eng. '57), I. G. Berg (Eng. '58, Inc. '56), A. Bowie (Scot. '48), W. W. Buchanan (Scot. '54, B.C. '56), E. A. Christenson (Alta. '44), W. F. Davey (Que. '48), G. L. Fortier (Que. '58), T. Greer (Ire. '58), J. I. Hauer (Que. '58), R. L. Maheu (Que. '52), M. Obolensky (Eng. '53), E. B. Streuber (Man. '51), S. A. Stringfield (Nfld. '56, Eng. '53), T. B. Tattersfield (Eng. '36), T. Welsh (Eng. '58, Inc. '57), K. S. Wilson (Que. '57).

WINDSOR C.A. CLUB

The first fall meeting of the club was held on September 22 at the Aviation Inn, Pt. Pelee. M. W. Dixon, vice president of the H. J. Heinz Company of Canada Ltd., spoke on the operations of the company. Afterwards the members made a tour of the huge plant at Leamington.

The second dinner meeting of the season was held at the Norton Palmer Hotel on October 27. M. A. Bradshaw, the president of the Institute, spoke on a number of the activities and problems which are before the Council at the present time. Twenty-six members attended and there was a lively discussion period on matters ranging from public relations to management consultants. F. H. Buck, the registrar of the Institute, was also a guest on this occasion.

EDMONTON C.A. CLUB

Denny Ross and Ben Shikaze were winners of the low gross and low net, respectively, in the September golf tournament at the Highland's Golf Club. Scores remained confidential because of the cool day and unfavourable weather encountered during the round.

One week later, on September 26, at the Corona Hotel, the members met and adopted a constitution prepared by a committee of past presidents, W. C. Howard, E. A. Geddes and G. L. Treacy, assisted by Bill Buchanan, club solicitor.

SAINT JOHN STUDENTS

The Chartered Accountant Students Society of Saint John held a social evening on October 24 at the Renforth Community Club to celebrate the end of examinations. A large number of students and chartered accountants attended. Special guests were John L. Helliwell, president of the C.I.C.A. and E. Michael Howarth, executive secretary.

CLASSIFIED ADVERTISEMENTS

All replies to box numbers should be sent to The Canadian Chartered Accountant, 69 Bloor Street East, Toronto 5, Ontario.

Rates: *Positions wanted, $7.00 per column inch; Positions offered, $10.00 per column inch; Open rate, $17.00 per column inch.*

Closing date is 13th of preceding month.

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